Effective Management of State Investments

A Report to the 49th Legislature Joint Interim Subcommittee No. 3

December 1984

Montana Legislative Council

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EFFECTIVE MANAGEMENT OF STATE INVESTMENTS

REPORT AND RECOMMENDATIONS

of

JOINT INTERIM SUBCOMMITTEE NO. 3

to

THE 49TH LEGISLATURE

Required by

HOUSE JOINT RESOLUTION NO. 4

48th Legislature

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HOUSE JOINT RESOLUTION NO. 4

A JOINT RESOLUTION OF THE SENATE AND THE HOUSE OF REPRESENTATIVES OF THE STATE OF MONTANA REQUESTING AN INTERIM STUDY OF OPTIONS AND ALTERNATIVES FOR INVESTING STATE RETIREMENT FUNDS, COAL TAX TRUST FUNDS, AND OTHER CASH FUNDS; REQUIRING A REPORT OF THE STUDY FINDINGS TO THE 49TH LEGISLATURE.

WHEREAS, inflation distorts the measurement of real yields on investments; and

WHEREAS, inflation increases future commitments of state retirement funds; and

WHEREAS, inflation may result in an inability of retirement funds to fund benefits for public employees, creating pressure on the general fund; and

WHEREAS, the permanent coal tax trust fund created by Article IX, section 5, of the Montana Constitution should be maintained in true purchasing power for future Montanans; and

WHEREAS, the Montana Board of Investments manages substantial public assets benefiting public employees, the general fund, and future Montanans.

NOW, THEREFORE, BE IT RESOLVED BY THE SENATE AND THE HOUSE OF REPRESENTATIVES OF THE STATE OF MONTANA:

(1) That an appropriate interim committee be assigned to study options and alternatives for investing state retirement funds, coal tax trust funds, and other cash funds.

(2) That the committee compare the costs of maintaining the Board of Investments to other states' investment systems and to private sector management of trusts and similar investment pools.

(3) That the committee examine the list of permissible investments in 17-6-211 and make recommendations for expanding or amending those permitted.

(4) That the committee examine the management of Montana's investment pool and consider the effects of inflation on the pool.

(5) That the committee study the flow of funds within the several retirement systems, giving special consideration to the effects of inflation on the funds, on retirement tax rates, and on benefits.

(6) That the committee closely examine the assumptions made in actuarial studies of state retirement funds, including a review of the studies by independent professional actuaries.

(7) That the committee report its findings and recommendations to the 49th Legislature and, if necessary, draft legislation to implement the recommendations.

Principal sponsor: Representative Ken Nordtvedt, R-Bozeman

Approved by the House of Representatives 93-7

Approved by the Senate 44-6

SUMMARY OF RECOMMENDATIONS

Joint Interim Subcommittee No. 3, responding to its charge under House Joint Resolution No. 4, recommended enactment of bills that would:

(1) provide representation from the boards of the Public Employees' Retirement System and the Teachers' Retirement System on the Board of Investments;

(2) authorize securities of the Federal Home Loan Mortgage Corporation to be pledged to secure deposits of public funds and thus qualify those securities as permissible investments for public funds;

(3) increase from two to six the number of positions on the staff of the Board of Investments excepted from the provisions of the state classification plan;

(4) submit to the electors a constitutional amendment to remove the restrictions on the investment of public funds and to provide that the "Prudent Expert" principle govern the investment of public funds; and

(5) conform the unified investment program with the constitutional amendments proposed in (4) and eliminate the statutory "laundry list" of permissible investments that dilutes the discretionary authority of the Board of Investments to make investment decisions.

The Subcommittee further recommended that:

(1) the Board of Investments and the Economic Development Board remain constantly vigilant of impending inflationary pressures and to recognize the costs of existing inflation so that portfolio adjustments, as far as practicable within constraints of the "Prudent Expert" principle, may reduce or eliminate loss of purchasing power;

(2) return of a portion of the interest from the permanent coal tax trust fund to the trust fund be continued at a level sufficient to maintain or enhance the real purchasing power of the fund; and

(3) the Board of Investments account for gains or losses resulting from bond swaps in a manner consistent with generally accepted accounting principles.

MONTANA'S INVESTMENT SYSTEMS

The responsibility for investment of public funds in Montana is shared by two agencies: the Board of Investments and the Economic Development Board.

The Board of Investments was created by the 1971 Legislature to centralize the responsibility for investing all public funds of the state of Montana on a panel of persons experienced in investment affairs who would select a trained, knowledgeable investment officer and staff to perform the day-to-day functions. The Constitution written and ratified for the State of Montana in 1972 mandates the unified investment program envisioned in the 1971 statute and requires separate identification of each fund.

The quasi-judicial Board of Investments consists of five members appointed by the Governor and has the sole authority to invest state funds except the Montana In-State Development Fund, which is administered by the Montana Economic Development Board created by the 1983 Legislature.

The Board of Investments is authorized to employ an investment officer and an assistant investment officer and to prescribe their duties and salaries. Since its inception 13 years ago, the program has had the same investment officer, and he is now one of the highest paid employees of the state.

The Constitution requires that all public school and university funds be "safely and conservatively invested" in public securities of the state, local governments or districts, bonds of the United States or

other securities fully guaranteed by the U.S., or "other safe investments bearing a fixed rate of interest."

Investment of public funds in private corporate stock is prohibited by the Constitution "except for monies contributed to retirement funds". The statutes establish strict qualifications for investment in corporate stock and limit such investments to 50 percent of any retirement fund, a ceiling that has never been approached.

The "Prudent Man" provision of the statute requires that the Board use the same "judgment and care" used by "people of prudence, discretion and intelligence" in the management of their own affairs, not for speculation but for investment. The Board is also required to consider the probable safety of capital as well as the probable income and preservation of capital during periods of sustained high inflation.

The discretionary power of the Board is further limited by a statutory "laundry list" of securities in which it is permitted to invest.

The Board is instructed by statute to direct the state's investment business to firms which maintain offices in Montana and to consider investments that will benefit the state's smaller communities. The state's investment business may be directed to out-of-state firms only when there is a distinct economic advantage to the state.

The Board is expressly authorized to invest in mortgage loans financed by the Board of Housing.

Separate from and independent of the Board of Investments is the Montana Economic Development Board, created in 1983 to implement Initiative 95, which was approved by the voters in 1982. The Economic Development Board is charged with investing one-fourth of all revenue deposited in the Permanent Coal Tax Trust Fund after June 30, 1983.

Designated as the "Montana In-State Investment Fund", this money is to be invested in new or expanding locally-owned enterprises to the long-term benefit of the Montana economy and to provide jobs for Montana residents.

Although the two boards are separate and independent, they are required by law to meet jointly twice a year as a unified investment board to coordinate investment strategies, policies, and programs.

The Montana Economic Development Board is a quasi-judicial board of seven members, appointed by the Governor, "broadly representative of the state, seeking to balance professional expertise and public interest and accountability...." The Board's membership must include representatives of the financial community, small business, agriculture, and labor.

During its first year of existence, the Montana Economic Development Board completed its organization, recruited a staff, and is now accepting and processing loan applications.

OPERATIONS OF BOARD OF INVESTMENTS

Montana is one of only three states in the Union that has a centralized investment agency. The other two are Minnesota and Wisconsin.

In the remaining 47 states, the investment functions are performed by a variety of fiduciary agencies, each responsible for a particular trust, retirement, or administrative fund.

Among the three states that utilize a centralized investment agency, only in Montana is that agency also responsible for an accounting function. Of the 17 people on the staff of the Montana Board of Investments when this Subcommittee began its study, nine--or more than half--were employed in the accounting section, with only eight actually involved in the investment process.

The Board of Investments is responsible for commitment and supervision of more than $1.78 billion and is one of only two state agencies authorized by state law to make investments. Prior to passage of the Executive Reorganization Act of 1971, responsibility for hundreds of millions of dollars in retirement and trust funds was scattered among various agencies and borne by employees of limited experience or training in investments. Month-end balances in demand bank deposits (earning no interest) averaged $27 million or more over the course of a year. Ultra-conservative investment restrictions complicated optimum use of funds and hindered investment efforts. Conditions changed with the adoption of the 1972 state Constitution and passage of statutory amendments

allowing greater discretion in investment decisions and in the purchase of higher yielding securities.

The Board of Investments publishes an annual report, and copies are provided all Legislators. The report for fiscal year 1984 was published after the Subcommittee completed its work and will be available to Legislators during the 1985 session. The 1984 report shows that on total investments of book value of $1.782 billion, earnings totaled $186 million. Performance of the individual funds varied according to the security holdings of each.

The asset mix of the Board of Investment's holdings during the 1984 fiscal year was U.S. government securities, 30 percent; corporate bonds, 53 percent; common stock, 5 percent; short-term securities, 4 percent; and Montana commitments, 8 percent.

Total cost of operation of the Board of Investments for the 1984 fiscal year was .039 percent of the assets managed. Standard charge by mutual fund managers is about 0.75 percent.

Maximum enhancement of earnings, consistent with the Prudent Man Rule, is the objective of the investment program because every dollar earned for state government is one that taxpayers will not have to contribute.

Total investments by funds, according to the Board's 1984 report:

Public Employees' Retirement System Fund	$	403,837,727
Teachers' Retirement System Fund		308,592,679
Treasurer's Fund		230,742,605
Permanent Coal Trust Fund		192,248,720
Trust & Legacy Fund		161,365,669
Highway Revenue Bond Funds		88,707,380
Other Funds		76,757,359
Workers' Compensation Fund		63,405,988
Other Retirement Funds		61,927,602
Educational Trust Fund		59,667,662
Long Range Building Funds		54,669,901
Resource Indemnity Fund		42,275,727
Common School Interest and Income Fund		21,138,455
Various University Funds		16,431,957
Other Short-Term Investment Pool Funds		5,122,589
TOTAL	$	1,786,892,020

Investment income for the 1984 fiscal year as shown by the Board of Investments annual report:

Public Employees' Retirement System Fund	$	40,615,456
Teachers' Retirement System Fund		30,222,754
Permanent Coal Trust Fund		23,597,937
Treasurer's Fund		23,048,654
Trust and Legacy Fund		17,541,642
Highway Revenue Bond Funds		8,920,186
Educational Trust Fund		7,173,333
Workers' Compensation Fund		7,120,644
Other Retirement Funds		6,716,856
Long Range Building Funds		5,293,246
Other Funds		5,050,924
Resource Indemnity Fund		4,509,923
Common School Interest and Income Fund		2,509,052
Other Short-Term Investment Pool Funds		2,504,854
Various University Funds		1,632,148
TOTAL	$	186,457,609

By types of investments, at the end of the 1983 and 1984 fiscal years, the Board's holdings were:

	1983	1984
Corporate Bonds	$ 819,757,926	$ 841,263,330
U.S. Government Securities	360,919,335	527,185,301
Canadian Obligations	104,122,491	88,395,998
Montana Mortgages	99,754,418	82,049,380
Common Stock	72,204,460	95,667,654
Bankers' Acceptances	90,814,524	78,030,478
Montana Certificates of Deposit	30,900,000	32,150,000
Commercial Paper	-0-	1,981,750
Other	2,157,256	1,969,691
TOTAL	$1,547,198,879	$ 1,782,125,113

The Board's 1984 report showed these income yields for the various funds:

All Funds	11.82%
Treasurers' Fund	10.45%
Short-Term Investment Pool	10.60%
Public Employees' Retirement System Fund	11.34%
Teachers' Retirement System Fund	11.12%
Trust and Legacy Fund	11.96%
Workers' Compensation Fund	11.64%
Highway Patrol Retirement Fund	11.34%
Judges' Retirement Fund	11.34%
Game Wardens' Retirement Fund	11.41%
Sheriffs' Retirement Fund	12.65%
Statewide Police Reserve Fund	13.16%
Resource Indemnity Fund	12.29%
Educational Trust Fund	13.88%
Permanent Coal Trust Fund	14.42%

SURVEY OF FINANCIAL COMMUNITY

To put the operations of the Board of Investments into the perspective of the people actively involved in the financial community and to fairly assess the performance of the Board, the Subcommittee in the early stage of its deliberations asked the researcher to interview a number of well-informed persons. This effort resulted in a 21-page report that stated in part:

Broad View Necessary

A former member confided that it was almost impossible for the Board of Investments to look bad in its first few years. "All you had to do was call in the idle money from state banks and put it to work at interest." The sudden surge in earnings was a bonanza for the general fund.

This former board member said the investment officer should be more than a stock specialist; he has to understand real estate and the function of the financial community in stimulating the economic health of Montana. State money invested in buying mortgages, he said, will benefit Montana more than the purchase of any corporate bond. Loans purchased from financial institutions recycle money into the state's business system through creation of construction jobs, generation of material and equipment sales, and expansion of the tax base. Changing the emphasis from mortgage investing to securities purchases in search of higher returns deprived the Montana economy of a flow of vital investment capital, he said, and he frowned on common stocks as an investment vehicle for public

money: "too risky, amounts to gambling regardless of yield." The investment officer, he surmised, sees securities as convenient vehicles in which relatively large amounts of cash can be invested each business day in a relatively few transactions without reviewing and passing on the value of many individual mortgage offerings.

The law requires the investment officer to carry out the policies of the Board, but this former board member said the investment officer makes investments and executes investment decisions that are ratified at the subsequent meeting of the Board.

This former board member believes the Board of Investments should have some members designated as representatives of the retirement funds.

Careful Appraisal Needed

The head of Montana's largest securities company said that in general terms he feels the Board of Investments has done well, and he would not disparage its results, although his firm has not had a dollar of state business since 1976. A meaningful appraisal of the Board's performance would require a careful study of its reports for the past three to five years, including bond and stock portfolios and other documents, and he had no reason to make such a review. He cautioned that offhand comments or personal opinions be avoided in assessing a function as important as that of the Board of Investments.

Commendation for Board

An officer of another local securities dealer had high praise for the performance of the Board of Investments and called it "one of the most sophisticated and efficient systems we do business with." He complimented the Board's bond and stock traders as among the most astute in the business.

His characterization of the Board was that it is "very conservative" and composed of members who take their responsibility and liability very seriously.

One of the problems the Board must contend with, he said, is the difficulty of making in-state investments because very few Montana companies can qualify under the statutory criteria.

Tighter Board Supervision Needed

A state official observed that the investment officer runs a very professional organization, and, in fact, does such a good job that the Board has relaxed its supervision and may not be fulfilling the oversight function expected of it. He saw problems with the reporting system which, while accurate, may misrepresent the yield of some funds--the Permanent Coal Tax Trust Fund, for example--that have grown quickly with a sudden input of new money so their earnings bases have grown much faster than other states'. The annual report should be modified to indicate that this fund is of relatively recent origin and is unburdened by old, low-yield investments. Despite the unquestioned fine performance of the

investment system, the Board for its first 10 years operated in the best of all circumstances.

This observer sees the need for legislative oversight and for the development of better legislative understanding of the investment processes.

Disposition of gains on bond swaps is regarded by this observer and others as a situation in which the Board's procedures are in conflict with the long-term well-being of the state. Citing an attorney's opinion and a departmental memorandum as authority, the Board considers the profit on bond swaps as income which it disburses to the general fund for appropriation by the next Legislature. An opposing school of thought holds that the difference between cost and selling price is actually capital appreciation, and that increase should go back to the fund from which the original investment came. The current practice not only denies the original fund the growth that will yield added dividends in future years but exaggerates the actual return on current investments.

An attempt to stem the decline in true value of trust funds was manifest in the adoption of the 1981 Nordtvedt amendment modifying the Prudent Man Rule to add preservation of purchasing power during a period of sustained high monetary inflation as a criterion in investment selection.

Concern about the composition and size of the Board of Investments was expressed because its members represent no statutorily designated constituencies and the retirement systems have no voice on the Board. Enlarging the Board's membership to seven would allow

two new members to be chosen from the retirement systems.

A matter of concern was that most, if not all, of the state's investment business goes to only a few brokerages firms, none of which is headquartered in Montana. While stock transaction commissions are readily identified, brokers' earnings on bond transactions are contained in the cost-price margin of the dealer. Though estimated to total several hundreds of thousands of dollars per year, profits of bond dealers selling to the Board are proprietary information not available to the public. Concern was expressed that, without the competitive interplay of a large number of brokers, the Board could become a dumping ground for bonds not moving in the market.

If investment income is being unwisely credited to interest rather than to capital appreciation, the Legislature itself may be the culprit because of its addiction to coal tax trust fund interest. The high earnings from that and other funds flowing into the general fund relieve the Legislature of pressure for tax increases to meet growing expenditures. The Legislature can mandate the disposal of bond swap profits, and if the lawmakers continue to deposit them in the general fund the erosion of the true value of the trust fund will in practice be sanctioned by the Legislature.

An alternative method to the state's management system would be to divide the portfolios into portions to be assigned to private investment firms who would provide a variation of viewpoints with resulting healthy diversification. This system would utilize the

judgments of several professionals rather than that of one man for a portfolio worth over $1.7 billion. In any private organization, no single portfolio manager would carry such an awesome load.

Such private contracting could be overdone: California is said to have at least 10 firms involved in management of state funds. Outside management might increase total operating costs.

Another option is segmenting the operations of the Board of Investments by assigning several portfolio managers complete responsibility for portions of the funds.

Any investment system should include an on-going independent performance appraisal, ordered by an independent authority such as the Legislature or the Governor, to establish a long-term perception of the success of the program in meeting its objectives.

Also suggested was addition to Montana law of a provision similar to one in Alaska defining income from permanent public funds. Interest received in a year is regarded as the income for that year, but the income available for disbursement is the lesser of the latest fiscal year's return or the average of the annual income of the last five years (Alaska Statutes Supplement, Sec. 37.13.140).

Critics Question Judgment

No segment of state government is immune from public comment, and some professional investors have been openly critical of the Board of Investments' policies

and procedures. Some have expressed doubts about the integrity of the Permanent Coal Tax Trust Fund if current management philosophy is prolonged. Rather than all of the income being distributed to the general fund, one critic believes principles of good trust management require that portions of income sufficient to preserve its true purchasing power should be added to the corpus of the trust. Without periodic incremental embellishment from earnings, and assuming existence of an annual inflation rate of five percent, the trust fund's purchasing power will decline by two-thirds in 20 years despite the preservation of the same total in dollars.

That concern does not embrace the retirement funds because all income flows back to the funds, whose annual contributions plus earnings less benefit payments are actuarially calculated to allow the corpus of the fund to grow apace with inflation.

Precise criticisms of the Board of Investments for recent activities were:

> During the high run-up of bond rates in the early 1980's, the Board's portfolios held many long-term, low-interest bonds actually amounting to a huge loss in ultimate purchasing power.
>
> A substantial share of the Board's assets, perhaps as much as 15 percent, is in Canadian bonds, not a prudent investment in light of Canada's monetary policies and governmental attitude.
>
> The Board purchases no SBA-guaranteed loans although they involve no risk, assure profits, and require no effort by the Board.

Profitable investment opportunities were said to be available in real estate, where very advantageous terms

are available in limited partnerships and the property would remain on the tax rolls.

The Board was criticized for failing to adequately inform the public of its operations. Minutes of its meeting reveal little beyond the names of persons attending, and the published agenda is only a bare outline, with no suggestion of topics to be considered.

Questioning the value of common stock as a hedge against inflation of the early 1980's, this critic said changing the law to allow greater investment of public funds in equity issues will not of itself close the inflation gap.

Chairman Cites Board's Accomplishments

The chairman of the Board of Investments, Joseph B. Reber of Helena, has answered critics in various speeches and letters. In managing more than three-score individual funds that together total well over $1.7 billion, the Board must distinguish between pension funds, trust funds and operating funds and base its actions on these distinctions.

During its 13-year history, the Board of Investments earned more than $1 billion for the funds under its management. The Board's 1984 annual report showed holdings in Montana mortgages of $100 million despite payoffs of more than $17 million in the last two years. The Board of Investments makes no direct loans; all loans are initiated by financial institutions and later sold to the Board. The Board has never rejected a

Small Business Administration loan and purchased all five SBA loans offered last year, totaling $408,991.

A significant impact on the Montana economy is the Board's purchases of certificates of deposit from financial institutions which inject capital into the state's credit flow. Purchases last year totaled $68.9 million, with $32.1 million outstanding at the end of the fiscal year.

A 1983 amendment allows investment of up to 10 percent of any fund it manages in Montana businesses, and this state development fund could reach $100 million if sufficient qualified investments are available.

Particularly important to the state's future are the pension funds whose significant characteristic is the very long-term nature of their financial liabilities. While commercial lending institutions deal with maturities of months, a year, or a few years, the liabilities of a pension fund usually do not mature for decades. This long-term feature makes pension funds a unique and reliable source of long-term capital for businesses and housing.

Appendix D is the complete text of a response by the Board of Investments, presented February 22, 1984, to the Subcommittee's staff report.

BOARD'S MEMBERSHIP AND STAFF

A proposal that the Public Employee's Retirement Board and the Teachers' Retirement Board should have direct input in the decisions on the investment of funds contributed by the members of their systems resulted in the recommendation of LC 11. The bill increases the membership of the Board of Investments to seven and requires the Governor to fill the two new positions by appointing one member from each of the retirement boards.

Calling attention to its disadvantage in attempting to recruit and retain qualified investment analysts and professional staff, the Board of Investments asked that the law be amended to raise to six from two the number of its personnel exempt from the state's classification and pay plan. With private investment firms paying substantially more to key personnel than the state classification plan allows, the Board found itself providing a kind of finishing school for investment officers who were enticed away by higher compensation. The Subcommittee recognized the problem and recommended the passage of LC 13 to allow the Board to prescribe the duties and salaries of four persons in addition to the investment officer and the assistant investment officer.

DEFERRAL OF BOND SWAPS' GAINS AND LOSSES

The Subcommittee focused particular attention upon the accounting procedures under which the Board of Investments defers gains and losses from bond swaps and amortizes the gains and losses over the shorter of either the remaining life of the bonds sold or of the replacement bonds purchased. The Legislative Auditor found this practice not in accordance with generally accepted accounting principles except for gains and losses occurring on bond swaps of the retirement systems.

The Subcommittee endorsed the recommendation of the Legislative Auditor and strongly urged the Board to conform to generally accepted accounting principles.

See Appendix C for a discussion of bond swaps' gains and losses.

"PRUDENT EXPERT" RULE

Essential to continuing improvement of its record of achievements in the environment of the mid-1980's, the Board of Investments told the Subcommittee, is the replacement of the existing "prudent man" rule with the "Prudent Expert" Rule and the loosening of statutory limits on the Board's discretion.

These changes, which also included repeal of the so-called "laundry list" of permissible investments in 17-6-211, MCA, were intended to widen the Board's discretionary authority to allow it to take advantage of opportunities presently beyond its capabilities.

Just how does a "Prudent Expert" differ from a "Prudent Man"? The distinction lies in a few words.

Section 17-6-201, MCA, now charges the Board of Investments to exercise ". . . that degree of judgment and care, under circumstances from time to time prevailing, which people of prudence, discretion, and intelligence exercise in the management of their affairs. . . "

The "Prudent Expert" standard is embodied in the Wisconsin law in this language: ". . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a similar capacity, with the same resources, and familiar with like matters exercises in the conduct of an enterprise of a like character with like aims".

In California, Proposition 21, submitted to the voters in 1984, couched the "Prudent Expert" standard in these

terms: ". . . shall discharge his or her duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims".

After reviewing these matters, the Subcommittee recommended for submission to the people LC 15, a constitutional amendment adopting, in language similar to the California Proposition 21, the "Prudent Expert" Rule in the management of investments. The Subcommittee further recommended a companion bill, LC 16, to replace the statutory "Prudent Man" Rule with the "Prudent Expert" Rule and to eliminate the "laundry list" of permissible investments.

"FREDDIE MAC" SECURITIES

Before the Subcommittee was even organized, the Legislative Council staff was contacted by the Federal Home Loan Mortgage Corporation (Freddie Mac) which requested an amendment of Montana's investment laws to assure that Freddie Mac securities are legal investments for Montana public funds.

George Griffin, legislative director, state relations, for Freddie Mac, appeared at the Subcommittee's April 20, 1984, meeting to explain the kinds of securities the agency issues to achieve its objective of creating a secondary market for conventional mortgages.

The law establishing Freddie Mac in 1970 included a provision temporarily preempting state laws to assure that Freddie Mac had a broad market for its participation certificates and other securities. This pre-emption made Freddie Mac securities legal investments in Montana regardless of the fact that Freddie Mac is not among the investments expressly authorized by Montana law. That preemption will expire June 30, 1985.

Mr. Griffin asked that Freddie Mac be added to the list of permissible investments in Montana law.

The Subcommittee acted favorably on Mr. Griffin's request by recommending for passage LC 12. That bill amends 17-6-103, MCA, to include Freddie Mac securities

among those authorized to secure deposits of public funds and thus by the reference in 17-6-211, MCA, become permissible investments.

The Subcommittee noted, however, that if LC 15 and LC 16 are enacted, the list of permissible investments will be eliminated entirely under the "Prudent Expert" Rule.

APPENDIX A

IMPACT OF INFLATION

Concern about the erosion of the purchasing power of the individual trust funds because of rising inflation was voiced repeatedly by Subcommittee members.

In response to their questions, the staff researcher applied the changes in the Consumer Price Index for five years to the deposits in the Permanent Coal Tax Trust Fund and developed this analysis:

IMPACT OF INFLATION UPON PERMANENT COAL TAX TRUST FUND

Value of each year's deposit in 1983 dollars
adjusted according to Consumer Price Index

Year of Deposit	Amount of Deposit	Purchasing Power 1983	Change	1983 - CPI Adjusted
1978	$ 6,262,370	$ 4,089,000	-35%	$ 9,518,240
1979	10,645,054	7,792,140	-27%	14,551,715
1980	23,000,000	19,090,000	-17%	27,600,000
1981	34,600,000	31,624,000	-9%	37,714,000
1982	42,600,000	41,322,000	-3%	43,878,000
Totals	$117,107,000	$103,917,140	-11.3%	$133,261,000

Earnings Flowing to General Fund During This Period

1978	$ 86,780
1979	950,026
1980	2,600,000
1981	6,490,000
1982	13,200,000
	$23,327,000

Decline in purchasing power during the period because of inflation was $13,190,000.

Because no part of earnings was allocated to the Trust Fund, real purchasing power of the Trust Fund declined 11.3% in five years. After June 30, 1983, 15 percent of income and earnings of the Permanent Coal Tax Trust Fund must be deposited in that fund and become part of the corpus, subject to further appropriation only by vote of three-fourths of the members of each house (17-5-704).

INCOME YIELD ON PERMANENT COAL TAX TRUST FUND

1983 - 15.33%

1982 - 14.83%

1981 - 12.02%

Average for three years - 14.06%

Assuming 3 percent as annual inflation rate and using 12 percent as the rate of yield, annual income would be $14,400,000 on principal of $120,000,000.

Allocation of 15 percent of earnings to trust fund corpus would be $2,160,000.

Inflation rate of 3 percent would meanwhile reduce the purchasing power of the corpus by $3,600,000.

Result will be that even with allocation of 15 percent of earnings to the corpus, purchasing power will decline by almost $1.5 million.

In current market conditions, yield would probably be less than 12 percent.

APPENDIX B

ACTUARIAL ASSUMPTIONS

Subsection (6) of HJR 4 called for an examination of the assumptions made in actuarial studies of state retirement systems, but the Subcommittee at its organization session decided the subject of actuarial assumptions belonged more properly in the study of Public Pensions under HJR 44, which it was also conducting. Therefore, the Subcommittee did not review actuarial assumptions in regard to HJR 4. The staff researcher did, however, prepare two study papers on the subject, which are included here in fulfillment of the charge in HJR 4:

UNDERSTANDING THE PURPOSE OF ACTUARIAL ASSUMPTIONS

A Report to
Interim Joint Subcommittee No. 3
By Paul E. Verdon, Staff Researcher
April 2, 1984

The intention of this paper is to outline simply and concisely the fundamentals of actuarial valuation. The purpose is to acquaint the members of Interim Joint Subcommittee No. 3 with those principles in anticipation of the discussion on April 20 by the retained actuary of Montana's public retirement systems, Mr. Alton Hendrickson of Helena. He will explain the assumptions upon which the actuarial valuations for Montana's public retirement systems are based.

Management of a retirement system so as to assure the satisfaction of the contractual obligation to provide pensions to its members requires that the plan's assets be invested to produce continuing income. Without these assured earnings on accumulated contributions, financing of a retirement plan becomes an impossible burden.

Basic to a successful pension plan is an informed estimate of future benefit obligations and of future earnings of the plan's assets. Satisfaction of this requirement is the function of the actuary, whose responsibility it is to determine the future demands and to calculate the level of current contributions required to meet those needs. The actuary's job is to estimate in advance the cost of a pension plan. The cost is the amount by which the benefits plus expenses exceed investment return. To determine this cost, the actuary must make certain assumptions about the future upon which to calculate estimated benefits, expenses, and investment return.

Actuarial assumptions are projections of future experience, based on knowledge of past experience with the employee group involved and with similar groups under similar circumstances.

Put another way, actuarial assumptions are the actuary's best estimates of the future values of the elements comprising the anticipated benefits and the date when such benefits will become payable.

Typically, actuarial assumptions are chosen conservatively, on the financially pessimistic side of probable experience.

Assumptions usually required in estimating the costs of pension benefits include but are not limited to:

- Investment performance
- Salary increase projections
- Average age at retirement
- Turnover among nonvested employees
- Life expectancy before and after retirement
- Rate and duration of disability
- Administrative expenses

The first two assumptions are economic. A commonly used rule is that each one-fourth percent increase in investment performance will result in a reduction of four to six percent in pension plan cost. The significance of the salary increase projection is apparent in the fact that a five percent per year average annual salary increase means that in 30 years the employee's salary will grow from $20,000 to $86,000. Recognition of general salary increases is necessary for realistic projections.

Life expectancy is relatively easily determined by consulting the mortality tables that are generally accepted in the insurance industry.

Turnover rates are less predictable than mortality rates and are subject to drastic changes that can substantially affect pension costs. A low turnover projection can cause rates twice as high as those based on a high turnover projection. A liberal vesting provision, however, tends to limit cost reductions from turnover. A single turnover rate for a group has little value; a schedule of turnover rates based on sex and age is required, with higher rates of turnover usually projected for each of the first three or four years of employment. Past experience of the particular group is not usually a reliable guide to future turnover.

By the very nature and purpose of the system, retirement age is obviously an important determinant of cost of benefit payments. Postponement by an average of one year beyond full benefit eligibility--without an accompanying increase in benefit amount--may reduce cost by seven to eight percent. A retirement age assumption may be made in the form of a table of percentages of eligible employees expected to retire at each age or as the weighted average age at which retirement is assumed.

Setting of disability rate assumptions is difficult because the definition of disability itself is a problem. Also to be considered are existence of alternative pensions, benefit levels, and rules on permissibility of other work by a disability pensioner.

The interest or investments assumption is intended to be a long-range assessment of what funds already invested, or now waiting investment, or yet to be invested in future years will earn, and is usually a conservative estimate.

Full funding of pension plans is a desirable goal, but it could produce contribution requirements so high as to be unacceptable. Annual contribution requirement is the normal cost plus a payment toward that part of the accrued liability not provided for by the plan assets.

Periodic actuarial valuation is necessary to refine the actuary's estimated cost as he recalculates the normal cost and unfunded accrued liability portions of the annual contributions requirement to determine if those components are progressing in an orderly fashion consistent with the funding method used.

A pension plan is usually considered to be "fully funded" when current assets are sufficient to "purchase" or cover the benefits based on past service for those who have not yet retired (the actuarial present value of accrued benefits).

An unfunded public pension plan could be regarded as a financial time-bomb. In the five years ending in 1975, about a third of the nation's public pension plans did not have actuarial valuations, and most of the plans lacking actuarial valuations were financed on a pay-as-you-go or other nonactuarial basis.

Pension planning is a long-range business, and assumption setting is the key step in actuarial valuations. A long lapse in adjusting price, wage and interest rate assumptions could severely undermine the soundness of

the plan. This unfortunate event is avoided in Montana through actuarial valuations of each public retirement plan every two years.

Actuaries speak a language that is little understood by those outside the profession. It is not important to be able to converse learnedly with the actuary, but it is helpful to understand basic terminology.

"Decrement assumptions" attach probabilities to various events of financial consequence: mortality rates, termination rates, disability rates, retirement rates.

"Increment assumptions" are used to construct future plan populations: population growth rates.

"Economic assumptions" derive the current year dollar value associated with each future pension-related contingency: salary progression, interest rate.

Assumptions are categorized as "explicit" or "implicit".

If an actuary uses a set of assumptions in which each assumption in isolation represents his best estimate of future experience, these are called "explicit assumptions". Another actuary may use a different set of assumptions which nevertheless produces the same costs and may be called "implicit assumptions": a lower-than-expected interest rate used in conjunction with a lower-than-expected salary progression. An infinite number of such combinations can produce identical pension costs and liabilities.

In the implicit approach, the actuary focuses on differences between economic assumptions rather than on

their absolute size. The explicit approach holds that each assumption is reasonable of itself as well as in relationship to other assumptions.

A difficulty inherent in any financial arrangement such as a long-term retirement plan is the question of whether projections of salary increases should be in today's "hard dollars" to pay tomorrow's "soft dollar" benefits. Funding the individual's expected progression up the salary ladder merely recognizes the consequence of commitments made and that a certain rate of merit increases plus promotions is statistically inevitable.

The frequent periodic actuarial valuations of Montana's public retirement plans appear to satisfy the requirements for regular reviews and the legislature has reacted promptly in the past to preserve the financial integrity of the systems.

SOURCES

Information contained in this paper is derived from these publications:

Thomas P. Bleakney, F.S.A., Retirement Systems for Public Employees (Homewood, Ill., Richard D. Irwin, Inc.)

Michael S. March, "Pensions for Public Employees Present Nationwide Problems," Public Administration Review, (July-August 1980).

John S. Perreca, "How to Understand Your Actuary--Almost", Pension World (October 1979).

Robert Tilove, Public Employee Pension Funds, A Twentieth Century Fund Report (New York, Columbia University Press) 1976.

Howard E. Winklevoss, Dan M. McGill, Glenn D. Allison, and Roy S. Neff, Public Pension Plans, Standards of Design, Funding and Reporting (Homewood, Ill., Dow Jones - Irwin).

PUBLIC EMPLOYEES' RETIREMENT SYSTEMS
ACTUARIAL ASSUMPTIONS

Prepared for Joint Interim Subcommittee No. 3
By Paul E. Verdon, Staff Researcher
Montana Legislative Council
August 16, 1984

State	Salary Increase	Investment Income
Alabama	6.75% @ 20 to 4.57% @ 65	7%
Alaska	8% first 5 yrs., 7% thereafter	8%
California	7%	8.5%
Idaho	6%	7.5%
Illinois	7%	7.5%
Indiana	6.5%	7.5%
Kansas	5%	6%
Minnesota	6.5%	8%
MONTANA	5.5%	7%
North Dakota	6%	7%
Oregon	6%	7.5%
South Dakota	6%	7%
Utah	5.25%	7.5%
Virginia	4.5% to 6.9%	6.5%
Washington	10% in first year, gradually lowering to 5% in 11th year	10% in first year, gradually lowering to 6.5% in 11th year
Wisconsin	6%	7%
Wyoming	6%	7%

Sources: Latest Annual Reports of Individual State Systems.

PAUL2/ee/PERS Actuarial Assumptions

TEACHERS' RETIREMENT SYSTEMS ACTUARIAL ASSUMPTIONS

Prepared for Joint Interim Subcommittee No. 3
By Paul E. Verdon, Staff Researcher
Montana Legislative Council
August 16, 1984

State	Salary Increase	Investment Income
California	7%	8.25%
Illinois	4.7% to 8.8%	7%
Indiana	--	3% real rate of return over salary increase
Kansas	5%	6%
MONTANA	5.5%	7%
Maine	5.5%	8.5% (6.5% if no COLA)
New York	5.5%	7%
North Dakota	6%	7%
Utah	5.25%	7.5%
Texas	Actual Experience	7.75%
Virginia	--	6.5%

Sources: Latest Annual Reports of Individual State Systems.

PAUL2/ee/TRS Actuarial Assumptions

EARNINGS OF MONTANA RETIREMENT SYSTEMS

	Public Employees' Retirement System			Teachers' Retirement System		
	Year-End Assets (millions)	Income (millions)	Return (%)	Year-End Assets (millions)	Income (millions)	Return (%)
1982-83	$353.2	$34.96	11.23	$265.3	$28.48	10.90
1981-82	304.3	28.82	10.55	233.2	21.72	10.23
1980-81	270.7	23.49	9.56	213.0	18.11	9.34
1979-80	244.3	19.32	8.78	192.9	14.94	8.53
1978-79	215.0	16.36	8.50	172.3	13.27	8.51
1977-78	186.4	13.19	8.10	152.9	10.71	8.00
1976-77	160.9	10.86	7.87	135.5	9.10	7.68
1975-76	139.1	9.15	7.34	118.7	7.71	7.20
1974-75	119.3	7.59	7.06	103.2	6.70	7.07
1973-74	103.5	6.35	6.83	93.1	5.96	6.98
1972-73	90.8	5.47	6.61	84.1	5.08	6.67
1971-72	80.9	4.57	6.42	73.0	4.40	6.12

Compiled from Annual Reports of State Board of Investments
By Paul E. Verdon
Staff Researcher for Interim Joint Subcommittee No. 3
April 30, 1984

APPENDIX C

DEFERRAL OF BOND SWAPS, GAINS, AND LOSSES

The policy of the Board of Investments in regard to deferral of gains or losses on bond swaps was the subject of discussion by the Subcommittee several times under HJR 4.

This matter was the subject of comment in the Legislative Auditor's report of the audit of the Board of Investments dated June 30, 1983. The pertinent sections and the response of the Board of Investments follow:

STATE OF MONTANA

BOARD OF INVESTMENTS

AUDIT REPORT

CONDUCTED UNDER CONTRACT BY

GIBLIN, RIGGS & ASSOCIATES

JUNE 30, 1983

STATE OF MONTANA BOARD OF INVESTMENTS
ALL OTHER FUNDS
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 1983

1. HISTORY AND ORGANIZATION

The State of Montana Board of Investments (the Board) was created by an act of the Legislature to invest and manage the State of Montana's investment funds on a centralized basis. The investments and the income therefrom are owned by various State of Montana agency funds and managed on their behalf by the Board.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Investments

Investments, except mortgages, are presented in the statement of investments managed at book value (original cost adjusted for discount and premium amortization where applicable). Mortgages are presented in the statement of investments managed at par value. Mortgage discounts are recorded in the accounting records of the applicable administering agencies. Current values for publicly traded securities are determined primarily by reference to market prices supplied to the Board by various brokerage houses. Unrealized market loss on investments managed decreased by $154,293,917 in 1983 and decreased by $3,513,545 in 1982. The investments managed relate principally to investments which will be held to maturity or otherwise disposed of at no significant loss to the fund.

Premium and discounts are amortized using the straight-line method over the life of the securities. An average life of eight years is used for amortization of mortgage discounts.

Bond Swaps

Bond swaps involve trading one security for another security having the same par value for the purpose of enhancing portfolio content and/or yield. The Board defers gains and losses resulting from bond swaps and amortizes such gains and losses over the shorter of either the remaining life of the bonds sold or the replacement bonds purchased. As shown in the accompanying financial statements the accumulated net unamortized deferred losses on bond swaps as of June 30, 1983 and 1982 and the net amortization of the deferred losses on bond swaps for the years then ended were as follows:

	June 30, 1983	June 30, 1982
Accumulated net unamortized losses on bond swaps:		
Agencies other than public retirement systems	$15,142,406	$16,171,930
Public Retirement Systems	24,100,484	26,720,176
Total	$39,242,890	$42,892,106

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

	For the Year Ended June 30, 1983	June 30, 1982
Net amortization of deferred losses on bond swaps:		
Agencies other than Public Retirement Systems	$ 1,513,670	$ 1,179,717
Public Retirement Systems	2,001,802	1,609,599
Total	$ 3,515,472	$ 2,789,316

3. INVESTMENTS NOT UNDER DIRECT CONTROL

Land and buildings, the cost of which are also included in investments managed in the accompanying financial statements, are not under direct control of the Board. The agencies administering these assets maintain control and provide the Board with the necessary financial information. Rental income from these buildings is included in the statements of investment income; however, occupancy and depreciation charges relating to the buildings are not material and have not been included in the statements of investment income.

The book value of land and buildings included in investments managed in the accompanying financial statements was $283,347 at June 30, 1983 and $292,621 at June 30, 1982.

4. SECURITIES LENDING

The Board has an agreement with Manufacturers Hanover Trust Company (Manufacturers) whereby Manufacturers would loan to other entities securities managed by the Board. During the period the securities are on loan, the Board receives a fee and Manufacturers must maintain collateral equal to 102% of the market value of the securities loaned. The Board retains all rights and risks of ownership during the loan period. Included in interest income in the accompanying financial statements is $233,304 for the year ended June 30, 1983 and $275,402 for the year ended June 30, 1982 of income from securities lending activities. At June 30, 1983 approximately $4,300,000 and at June 30, 1982 approximately $9,400,000 of securities included in these financial statements had been leased by Manufacturers to other entities.

DEFERRAL OF BOND SWAP GAINS/LOSSES

Bond swaps involve trading fixed income securities, such as bonds, debentures and mortgages, for other fixed income securities having the same par value for the purpose of enhancing portfolio content, but primarily to improve yield. Because of increasing interest rates in current years, the market value of older securities has declined. As a result of this current market condition, this exchange of securities often gives rise to a loss on disposal of the older security.

There are currently two ways of accounting for gains and losses on exchanges of debt securities. One method is known as the completed transaction method which recognized the gain or loss on a sale of a security at the time of the sale. The other method is the deferral and amortization method which recognizes a deferred gain or loss at the time of the sale and amortizes the deferral over the remaining life of the new (or old) bond. The Board uses the deferral method and amortizes gains and losses over the shorter of either the remaining life of the bonds sold or the replacement bonds purchased. The Board uses the deferral method on bond swaps because it is their belief that the recording of these losses in the financial statements of the participating funds would seriously affect these funds' ability to distribute their income and provide benefits and service. The Board also feels no sale should be recognized since the affect of the sale and repurchase of securities leaves the fund in essentially the same position as before.

At this time, the deferral and amortization method of recording gains and losses on bond swaps is not in accordance with generally accepted accounting principles except for gains and losses occurring on bond swaps of Public Employees' Retirement Systems. Statement 6, "Pension Accounting and Financial Reporting: Public Employee Retirement Systems and State and Local Government Employees" was adopted on April 7, 1983 by the National Council on Governmental Accounting. It makes it acceptable to defer gains and losses on bond swaps occurring in public employee retirement systems of state and local governments, however, other funds must be accounted for using the completed transaction method.

RECOMMENDATIONS

We recommend that the Board use generally accepted accounting principles in relation to the accounting of bond swap gains and losses. However, we also recommend the the Board provide information with respect to bond swap gains and losses to the various agencies and the Legislative Auditor, if requested. This would enable the various agencies to adjust their financial statements in accordance with generally accepted accounting principles.

MANAGEMENT COMMENTS

We do not concur (See page 31).

DEPARTMENT OF ADMINISTRATION
BOARD OF INVESTMENTS

TED SCHWINDEN, GOVERNOR CAPITOL STA

STATE OF MONTANA

(406) 449 2656 HELENA MONTANA

November 16, 1983

Giblin, Riggs & Associates
First Federal Savings & Loan
Suite 206
2502 East Pikes Peak Avenue
Colorado Springs, CO 80909

Dear Mr. Giblin:

Our response to your recommendations is as follows:

DEFERRAL OF BOND SWAP GAINS/LOSSES

Management Comments - We do not concur.

All long-term investment funds we manage have basically the same investment goals as the retirement funds. In the majority, when bond swaps occur in the retirement funds, the same swap occurs in other long-term funds. For consistent accounting, which is a general acceptable accounting principal, it is incomprehensible to us that we treat the same transaction different from the other.

The auditor's suggestion is unreasonable and is contradictory.

PHYSICAL EXAMINATION OF MORTGAGES

Management Comments - We concur.

All exceptions have been corrected.

Sincerely,

James R. Howeth
Investment Officer

JRH/ns

APPENDIX D

BOARD OF INVESTMENTS' RESPONSE

At the second meeting on January 13, 1984, the Subcommittee posed these questions to the Board of Investments, whose response is contained in the following report presented at the February 22 meeting.

1. How do you respond to the questions posed in subsections (2) through (6) of HJR 4?

2. Do you have any recommendations for changes in permissible investments (17-6-211)?

3. What are the effects of inflation upon the various funds? What should be done to prevent diminution of purchasing power?

4. How is bond appreciation treated and why?

5. Which brokers does the Board trade through and how are brokers selected?

6. How does the securities lending program function?

7. What is the policy of the Board in regard to the purchase of Montana mortgages?

8. Is five the optimum number of members for the Board? Should the size of the Board be increased or reduced? Should the retirement systems be represented?

9. Would the state benefit by dividing the funds into smaller parcels to be managed by private firms under contract?

10. Should the Board actively seek SBA-guaranteed loans? Wyoming is said to have a standing invitation to accept all; should Montana adopt the policy? Would real estate limited partnerships be prudent investments?

11. How much of the state's portfolios is invested in Canadian securities? How do these compare with other investments?

12. What is the Board's policy on long-term investments? What is the current purchasing policy and how are the decisions made?

13. Should the proposed constitutional amendment to allow investment of funds other than retirements in common stocks be resubmitted to the people?

14. Do you have any other suggestions for legislation to improve the performance of the Investment Division?

REPORT TO THE LEGISLATIVE JOINT INTERIM SUBCOMMITTEE NO. 3

From: The Board of Investments

Introduction

This is the response to this Committee's report on the Board of Investments and to answer questions which have arisen as a result of your study.

We are extremely proud of our performance. When comparing our performance figures with other similar funds, the State of Montana consistently ranks among the best. It is easy to second guess investment decisions. There are probably few subjects as opinionated as investments. However, let us assure this Committee, there have been many difficult decisions made over the past years, and looking back, we are proud of our many accomplishments.

Costs

Comparing the cost of Montana's investment system to other systems is not an easy task. We are the only state, that we are aware of, that has both the investment and accounting responsibilities. Approximately 45% of our budget is expended for accounting. Also, we are only one of two states which have centralized investments. We are only one of two states which manages all funds internally. Most states do not publish the cost of internally managed funds. Montana's cost of 43¢ per $1,000 invested compares favorably with other states which publish their cost. South Dakota Investment Council reported a cost of 53¢ per $1,000. However, they have four external managers whom they pay a range of $4.12 to $20.32 per $1,000. Wisconsin Investment Board manages $8.5 billion internally for a cost of 19¢ per $1,000; however, they have no accounting responsibilities. South Dakota reports the industry average is $3.50 per $1,000. External managers will cost $2.5 million to $10 million for each $1 billion. Most states are forced to hire external managers because qualified personnel cannot be hired on appropriated budgets. The Board does not know of any benefits the State would derive from hiring private firms to manage smaller parcels.

Board Members

The Board would not support expansion in the number of board members. We believe there is sufficient communication between the retirement boards and the investment process. We also believe the current situation provides the flexibility and control that is required in making investment decisions. Should this Committee give credence to one former board member, we would suggest all former members be interviewed. It is essential to maintain the requirement that board members have investment experience. This is necessary for the Board to effectively maintain control over a professional staff.

Recommendation

The Board would support the repeal of the permissible list. Any investment manager that has the flexibility to invest in any economic

environment, whether it be an inflationary or a deflationary environment, should have a superior performance. We would recommend amending the constitution to the "Prudent Expert Rule". This standard means the Board's actions must be compared to those of other prudent retirement or public fund managers, rather than to the actions of an average prudent person not necessarily experienced in investment matters.

It is of little use for the legislature to mandate the Board consider the effects of inflation on funds and not give the Board the tools to combat these external factors.

Capital Gain and Losses

The Board is the only state agency that the constitution requires to have annual audits. Our accounting methods use general acceptable accounting principles and the treatment of capital gains and losses follows these principles. Any change in accounting methods would require legislative action.

Brokers and Dealers

The Board endeavors to do business with investment firms who have offices in the State; however, we strive to do business through firms which offer the lowest net prices relative to services rendered. Other criteria used are: general trading capability; commission rates; underwriting position; financial strength of the firm; quality, breath, and depth of company and industry research reports; other selected investment-related services; and the level of responsiveness to our requirements. Attached are the names of firms, amount of equity commissions, and the par value of bonds executed with individual firms.

Mortgages

Montana was one of the first states to initiate the purchase of real estate mortgages for retirement funds. We currently own over $90 million in commercial and residential real estate mortgages. One portfolio manager's full-time is devoted to underwriting and purchasing of real estate mortgages. 90 percent of all real estate mortgages offered to us are purchased. The remainder are rejected because they do not meet statutory requirements or underwriting guidelines. All mortgages are purchased from Board approved sellers which includes most banks and savings and loans within the State. All sellers have been provided the Board's manual containing the laws governing real estate mortgages, Board policies, and underwriting guidelines.

SBA Loans

On a daily basis, we bid on SBA offerings. Bids are approximately one percent above comparable government bond rates.

Real Estate

Real estate investments should be considered when rates of return are comparable to other competitive investments and the fund's liquidity needs are not endangered. It is difficult for non-taxable funds to compete with taxable funds in the real estate market.

Canadian Bonds

As reported in our June 30, 1983, Annual Report, Canadian obligations account for 5.7% of the total portfolios. Canadian bonds have 15 years of call and refunding protection; whereas, comparable U.S. corporate bonds offer 5 years of protection. Generally, a Canadian bond will yield .25 basis points more than a comparable U.S. corporate bond.

Securities Lending

All marketable securities are held in a safekeeping account with Manufacturers Hanover Trust Company. We have an agreement whereby Manufacturers will loan to other entities, securities which are held in safekeeping. During the period the securities are on loan, we receive a fee and Manufacturers must maintain collateral from the borrower equal to 102% of the market value of the securities loaned. We retain all rights and risks of ownership during the loan period. Over $1 million has been earned for the various funds since the program began.

Investment Policies and Objectives

Fixed Income Securities

Investment in fixed income securities will be made to obtain the highest possible rate of return. Consideration will be given to the legal permissible list, the Prudent Person Rule, current and future economic conditions, current and future interest rates, yield spreads, the yield curve, and the cash-flow needs of the individual retirement fund. An active bond-trading program will be maintained to increase yields. Performance will be measured in relation to the Lehman Kuhn Loeb Index and the Salomon Brothers Index.

Mortgages

Investment in Montana commercial and residential mortgages will be purchased on a competitive rate of return basis.

Common Stock

Investment in common stocks will be used for protection against the long-term inflationary effects on assets. The degree of use will depend upon current and long-term economic conditions, rates of return

obtainable on other legal investments, and the cash-flow of the individual retirement fund. Individual stock selections are made through the Board's approved list containing over 100 companies. The Investment Officer may purchase or sell any stock on the approved list. Additions and deletions are made through the investment staff presentations for Board approval. The long-term total rate of return on equities should equal the total rate of return on the Standard & Poors 500 stock index funds.

Public Trust Funds

Fixed Income Bonds - Investment in bonds will be made to obtain the highest possible rate of return. Consideration will be given to the legal permissible list, the Prudent Person Rule, current and future interest rates, the yield curve, and the cash-flow to the individual fund. An active bond trading program will be maintained to increase yields. Performance will be measured in relation to the Lehman Kuhn Loeb Index and the Salomon Brothers Index.

Mortgages

Investment in Montana commercial and residential mortgages will be purchased at a competitive rate of return basis. Purchases of mortgages will not be made for any trust fund where liquidity is a concern.

SBA & Other Governmental Securities

Investment in these securities will be made approximately one percent above government bond rates which have comparable maturities.

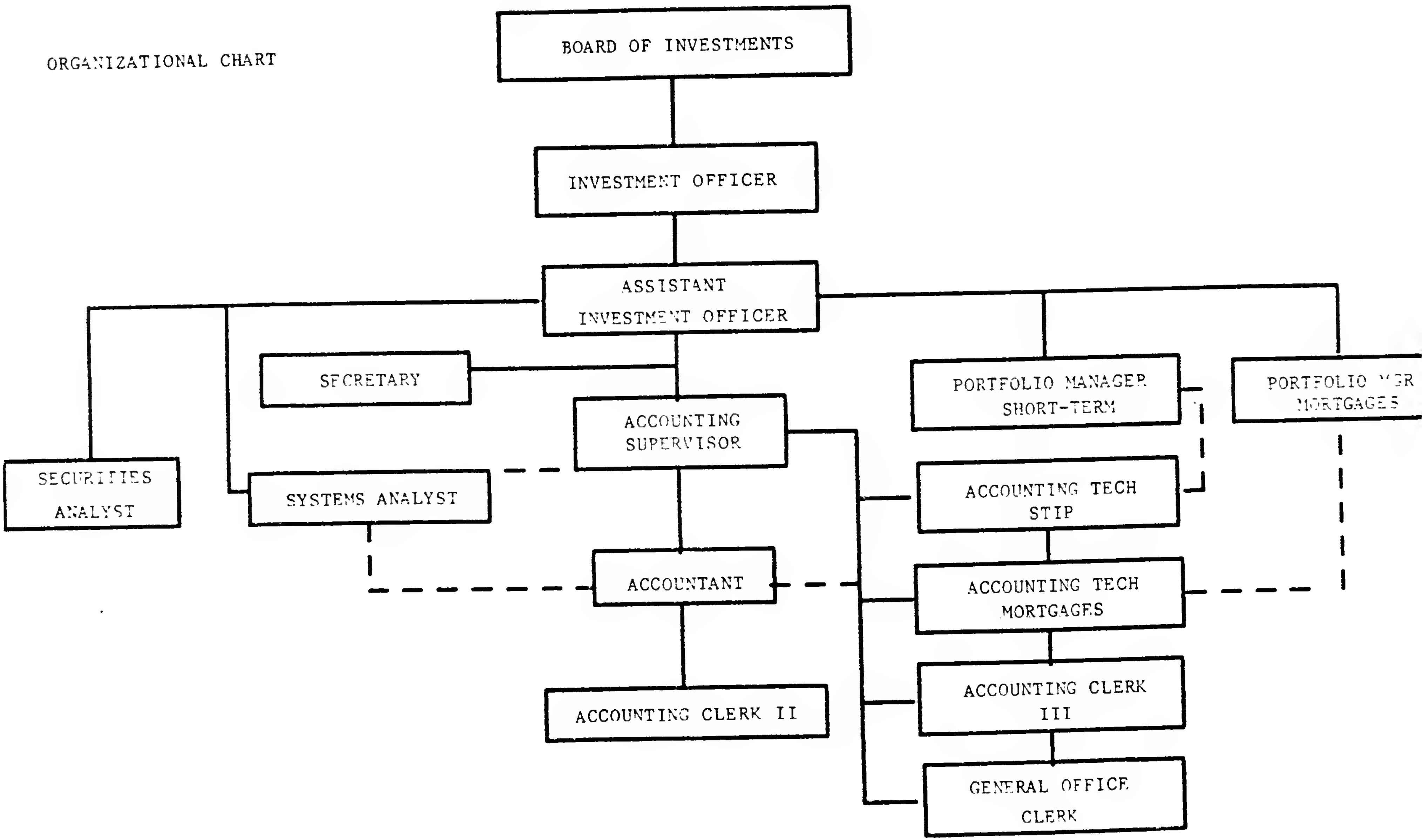
Real Estate

Investment in real estate will be considered when rates of return are comparable to other legal investments and where liquidity is not a concern.

Operational Funds

Fixed Income Securities - Investment in fixed income securities will be made to obtain the highest possible rate of return. Consideration will be given to the legal permissible list, the Prudent Person Rule, and the liquidity needs of the individual fund. Investments will be made according to the current and future interest rates, yield spreads among the various types securities and the yield curve.

ORGANIZATIONAL CHART



FYE 1982

BROKER	COMMISSION	% TOTAL
Dain Bosworth	$24,787.77	28.10
G.T. Murray	23,799.89	26.98
Paine Webber	23,347.74	26.46
Piper Jaffray	16,286.00	18.46
	$88,221.40	100.00%

EQUITY COMMISSIONS
FYE 1983

BROKER	COMMISSION	% TOTAL
G.T. Murray	$33,048.15	38.77
Paine Webber	21,106.14	24.76
Dain Bosworth	20,629.57	24.20
Piper Jaffray	10,460.30	12.27
	$85,244.16	100.00%

DEALERS
FYE 1983

DEALER	PAR VALUE 1
Drexel Burnham	$160,429,000
L.F. Rothschild	149,975,000
Salomon Bros.	117,141,692
Kidder Peabody	86,175,000
Bear Stearns	79,095,000
Lehman Bros.	57,210,000
Merrill Lynch	34,130,000
Paine Weber	29,032,000
Dean Witter	26,000,000
Morgan Guaranty	11,500,000
Bank of America	11,030,000
Dominion Securities	8,800,000
Bache for G.T. Murray	7,786,050
Smith Barney	4,000,000
Dain Bosworth	3,000,000
Piper Jaffray	3,000,000
Wertheim	1,000,000
	$789,303,742 2

1. Includes government and corporate bonds purchased and sold with five or more years of maturity.

2. Includes $331 million in bonds swaps and private placements.

APPENDIX E

INVESTMENT ADVISOR'S COMMENTS

The investment firm of Scudder, Stevens and Clark has been retained by the Board of Investments for consulting services and to calculate certain data for the Board's annual reports.

At the subcommittee meeting of February 22, 1984, Gary Coburn, a general partner in that firm, presented these documents to explain the operations of the Board:

MONTANA BOARD OF INVESTMENTS MEETING

February 22, 1984

I. Investment Environment

A. Decade of the 1970's a very difficult period
B. Physical assets (real estate, gold etc.) produced higher returns than financial assets (stocks and bonds) from 1972-82
C. Financial assets came into their own in late 1982-83 as the rate of inflation declined sharply

II. Investment Objectives of the Montana Funds

A. The investment objective should be to maximize total return within proper risk tolerance
B. Total return is defined as the sum of income plus the change in market value

III. Fund Characteristics

A. The two Retirement Funds and the Workman's Comp. fund have similar investment objectives and characteristics

B. The Coal Tax, Trust & Legacy and Educational Funds probably have similar objectives and similar characteristics

IV. Performance - Retirement Plans & Workman's Comp.

A. Equity comparisons track closely with the S&P500 and median performance of the A.G. Becker sample

B. Bond comparisons over the past 5-7 years are slightly ahead of the market averages. Over the past two years, the bond results are far superior to the averages and the A.G. Becker sample.

V. Conclusions - Retirement Plans & Workman's Comp.

A. Retirement Funds and Workman's Comp. Fund are meeting investment goals

VI. Coal Tax, Trust & Legacy and Educational

A. The impact of reinvesting only a portion of the income is significant in terms of the ability to preserve the purchasing power

B. There are only two ways principal can grow in order to offset inflation

1. Equity investments can be purchased such as real estate or common stocks - currently not allowed

2. Income can be reinvested to provide a small cushion against rising inflation - only partially allowed

C. The stated goal of preserving the purchasing power should be re-examined

VII. Conclusions

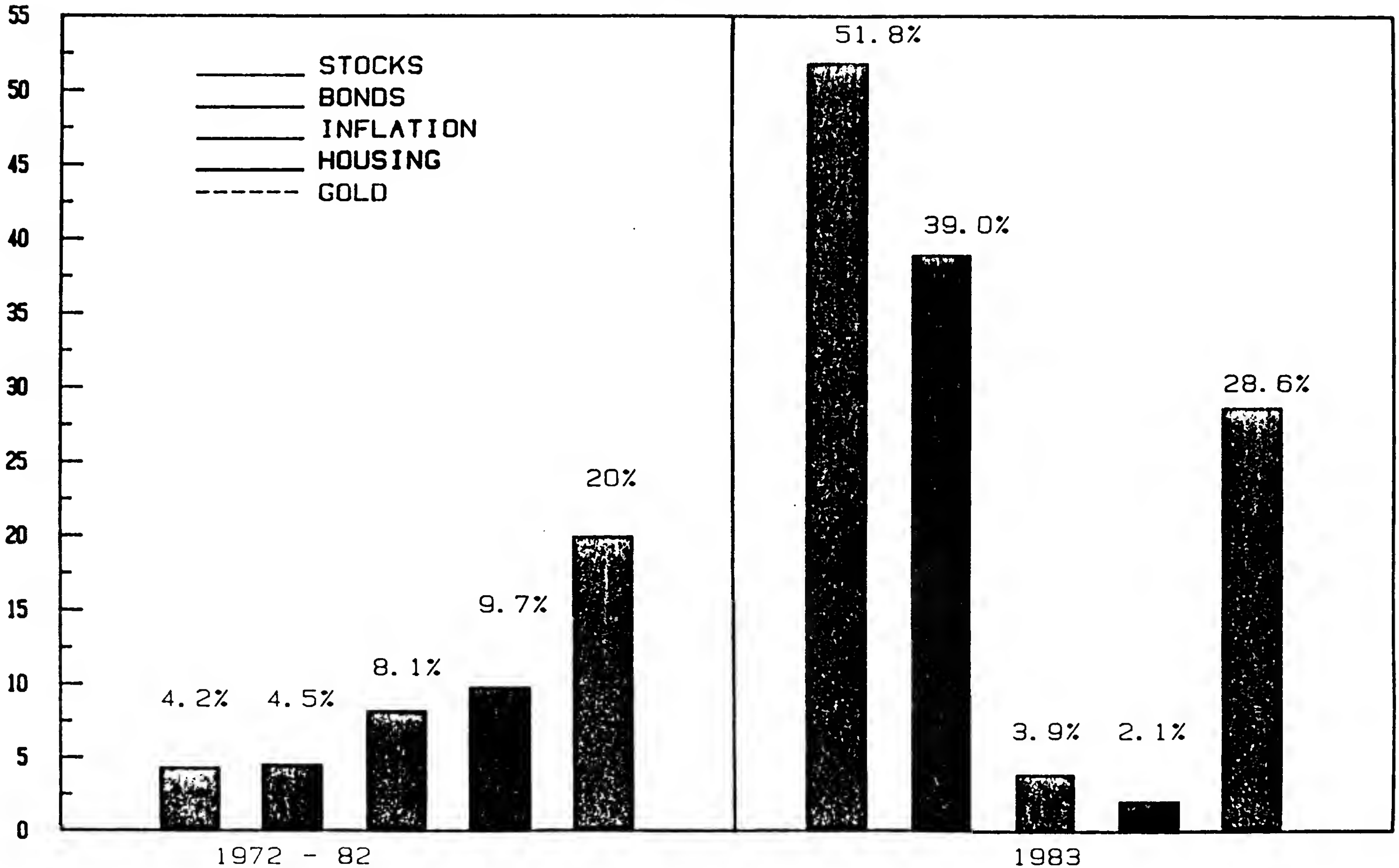
A. The tools to earn real returns in the Coal Tax, Trust & Legacy and Educational Fund are not provided

B. However, there are other objectives besides earning a real return that are being met under current policies and procedures

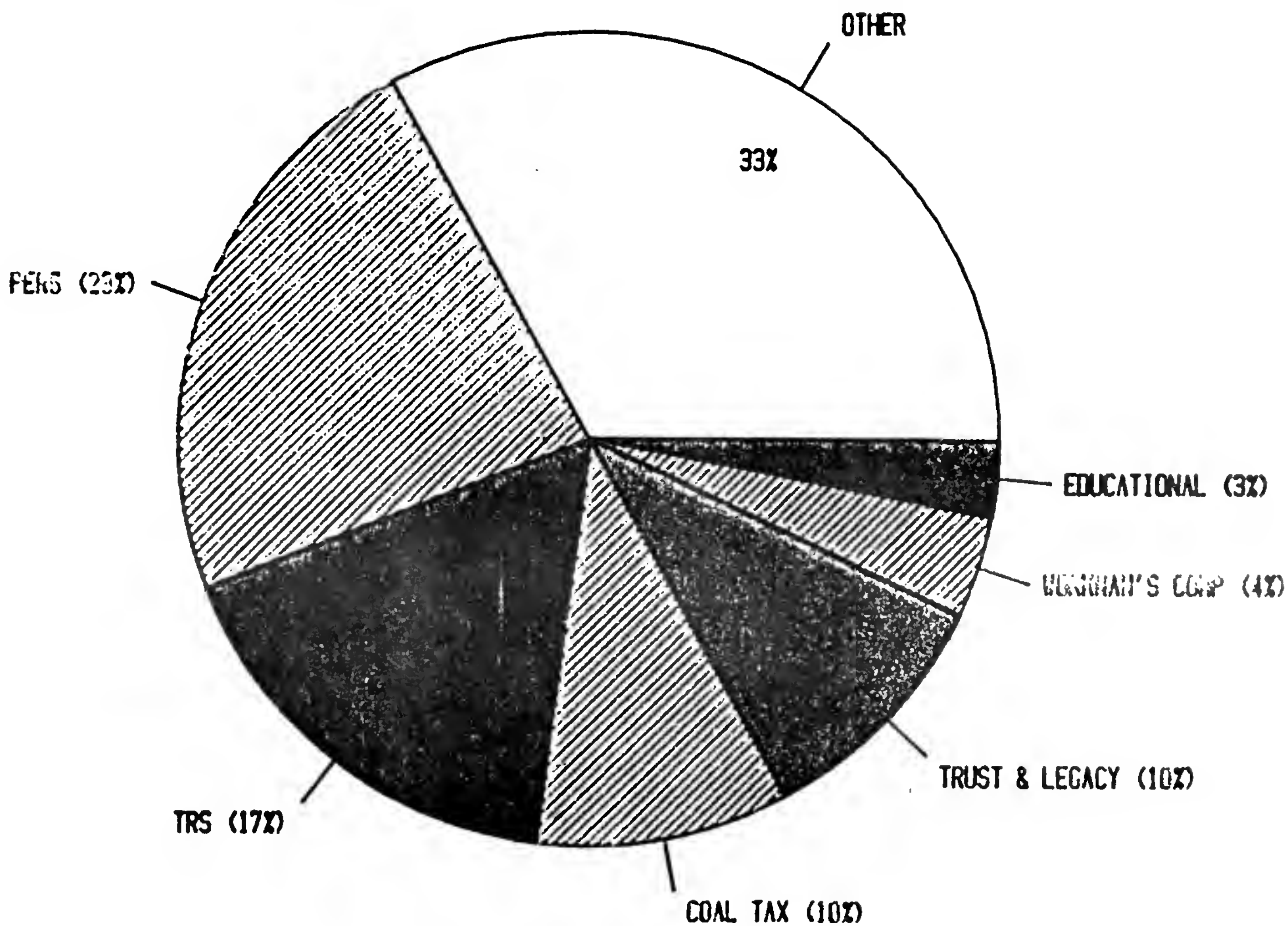
C. The Legislature must weigh the trade-offs between spending current income now versus reinvesting income and preserving the purchasing power in the future

INVESTMENT ENVIRONMENT

PERIODS ENDING JUNE 1



MONTANA INVESTMENT FUNDS



OBJECTIVE

MAXIMUM TOTAL RETURN WITHIN PROPER RISK TOLERANCE

MEASURING TOTAL RETURN

SUM OF YIELD PLUS APPRECIATION OR DEPRECIATION

$$\frac{\text{INCOME} + \text{CHANGE IN MARKET VALUE}}{\text{MARKET VALUE}} = \frac{\$5 + \$10}{\$100} = 15\%$$

Fund Characteristics

Retirement Funds/Workmans Comp.

Characteristics:

Positive cash flows

Long term liabilities

Long term investment horizon

INCOME IS REINVESTED

Objective:

Maximum total return

Preservation of purchasing power is important

Investment Vehicles Allowed

	Bonds	Stocks
Ret.Funds	Yes	Yes
Workmans Comp	Yes	No

Coal Tax/Trust & Legacy/Education

Characteristics:

Strong cash flows

No specific liability to be funded

Long Term investment horizon

INCOME ONLY PARTIALLY REINVESTED

Objective:

Maximum total return

Preserve purchasing power for future generations?

Maintain existing levels of expenditures?

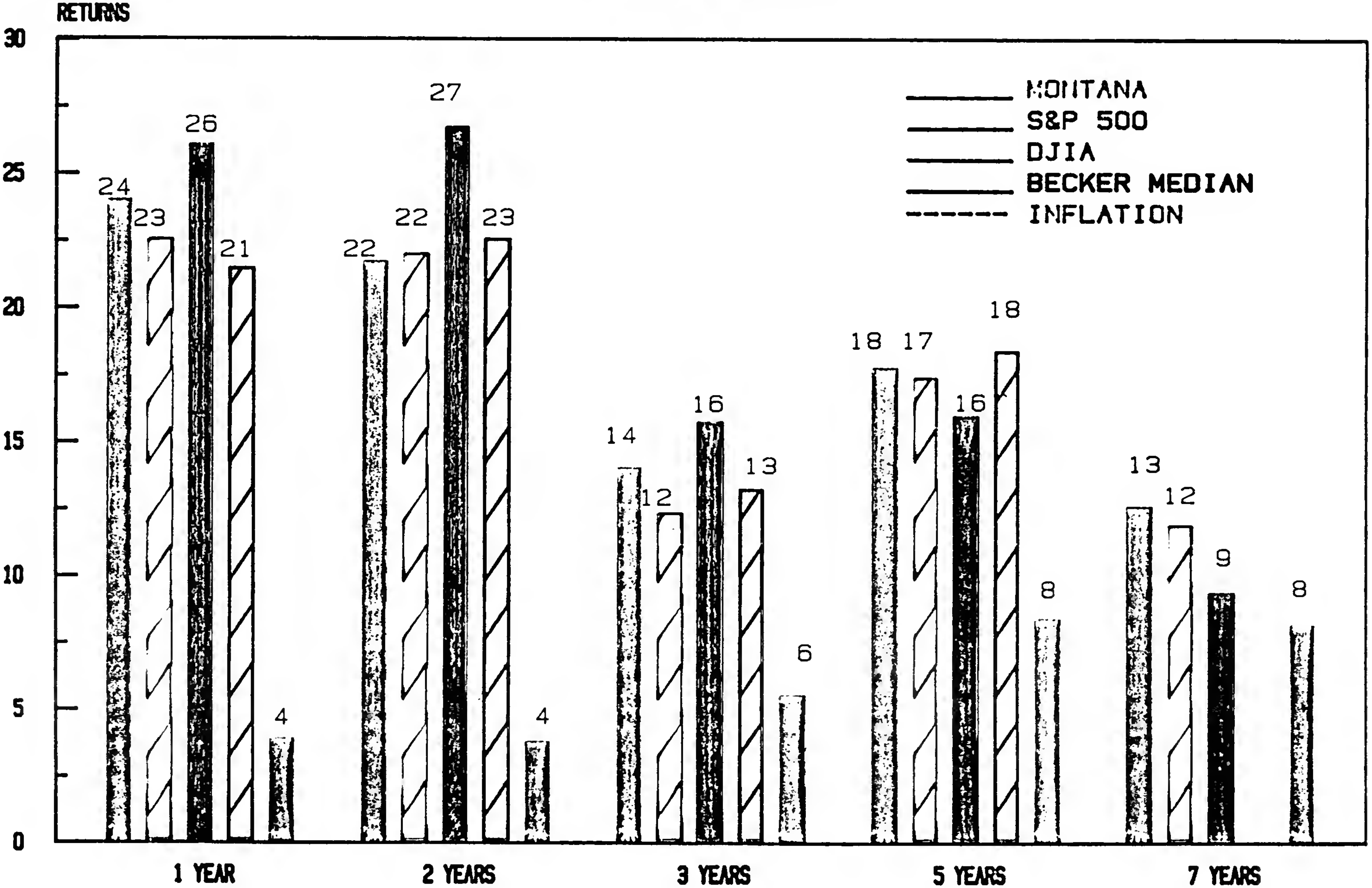
Combination of both?

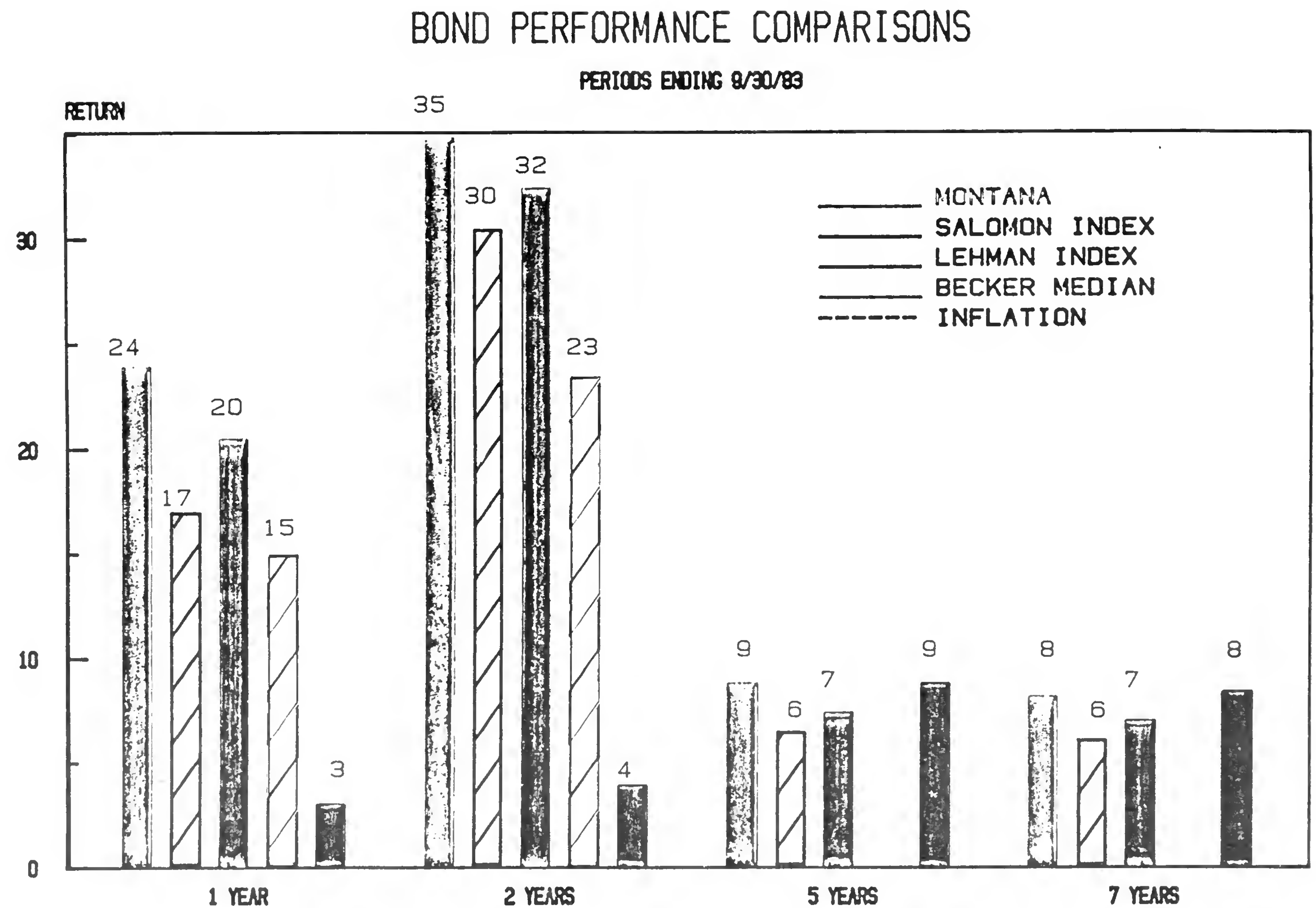
Investment Vehicles Allowed

	Bonds	Stocks
Coal Tax	Yes	No
Trust & Legacy	Yes	No
Educat'l Fund	Yes	No

EQUITY PERFORMANCE COMAPRISONS

PERIODS ENDING 12/30/83





BOND PERFORMANCE COMPARISONS
PERIODS ENDING 9/30/83
RETURN
30
20
10
0
24
17
20
15
3
35
30
32
23
4
9
6
7
9
8
6
7
8
MONTANA
SALOMON INDEX
LEHMAN INDEX
BECKER MEDIAN
INFLATION
1 YEAR
2 YEARS
5 YEARS
7 YEARS

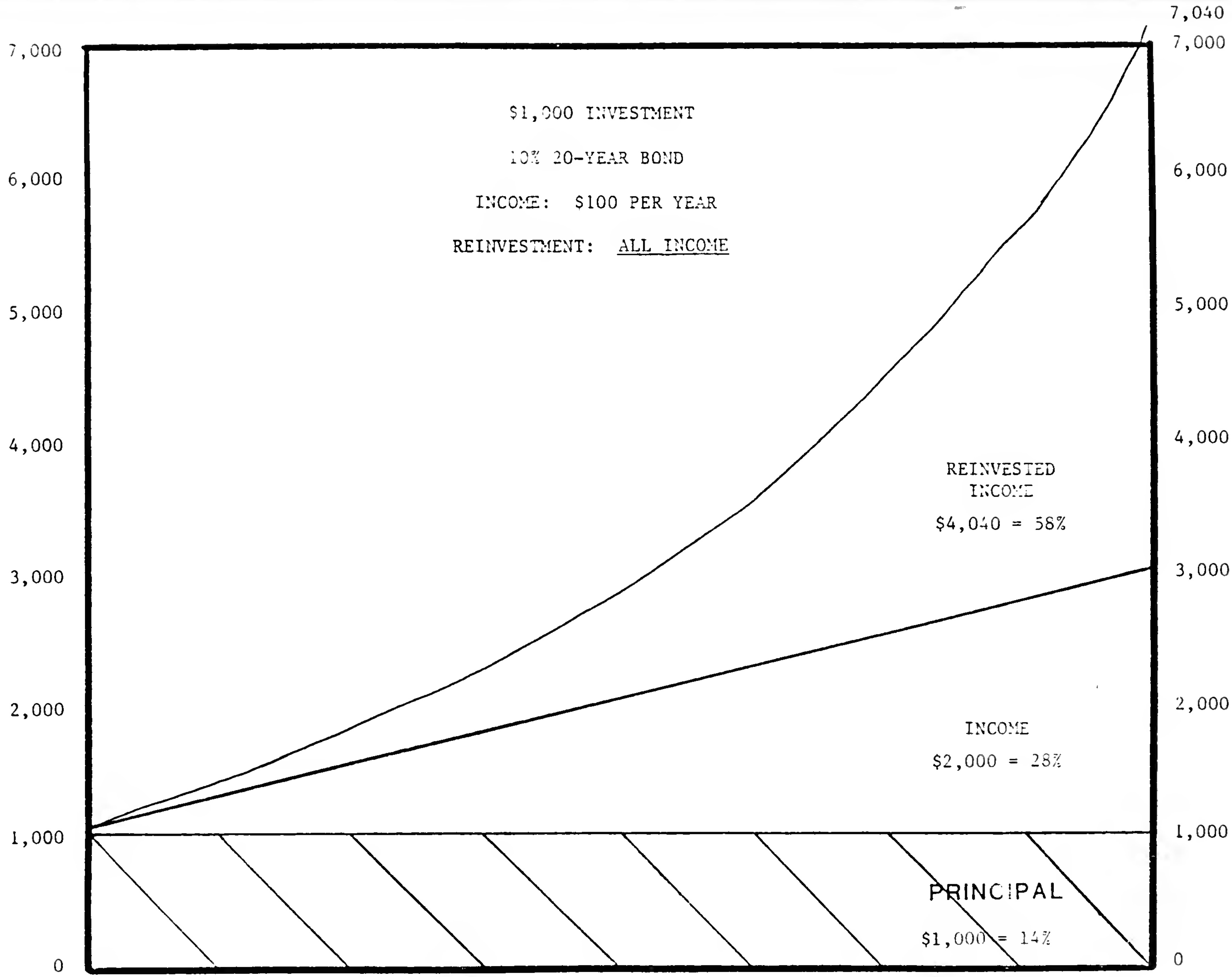
CONCLUSIONS

--- TOOLS ARE AVAILABLE TO MEET RETIREMENT FUND AND WORKMAN'S COMP. OBJECTIVES

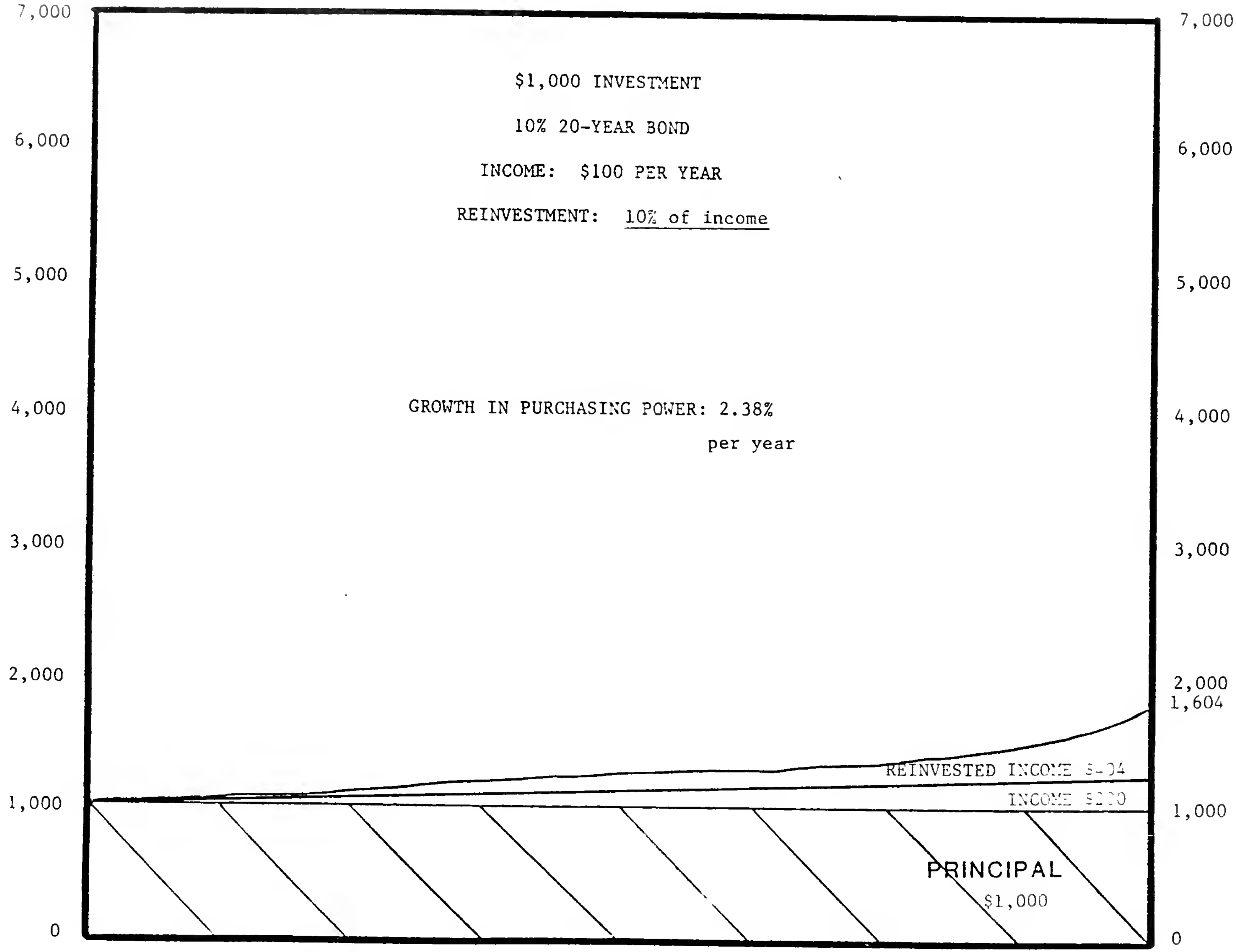
--- THESE TOOLS HAVE BEEN USED ADVANTAGEOUSLY IN THE PAST 10 YEARS

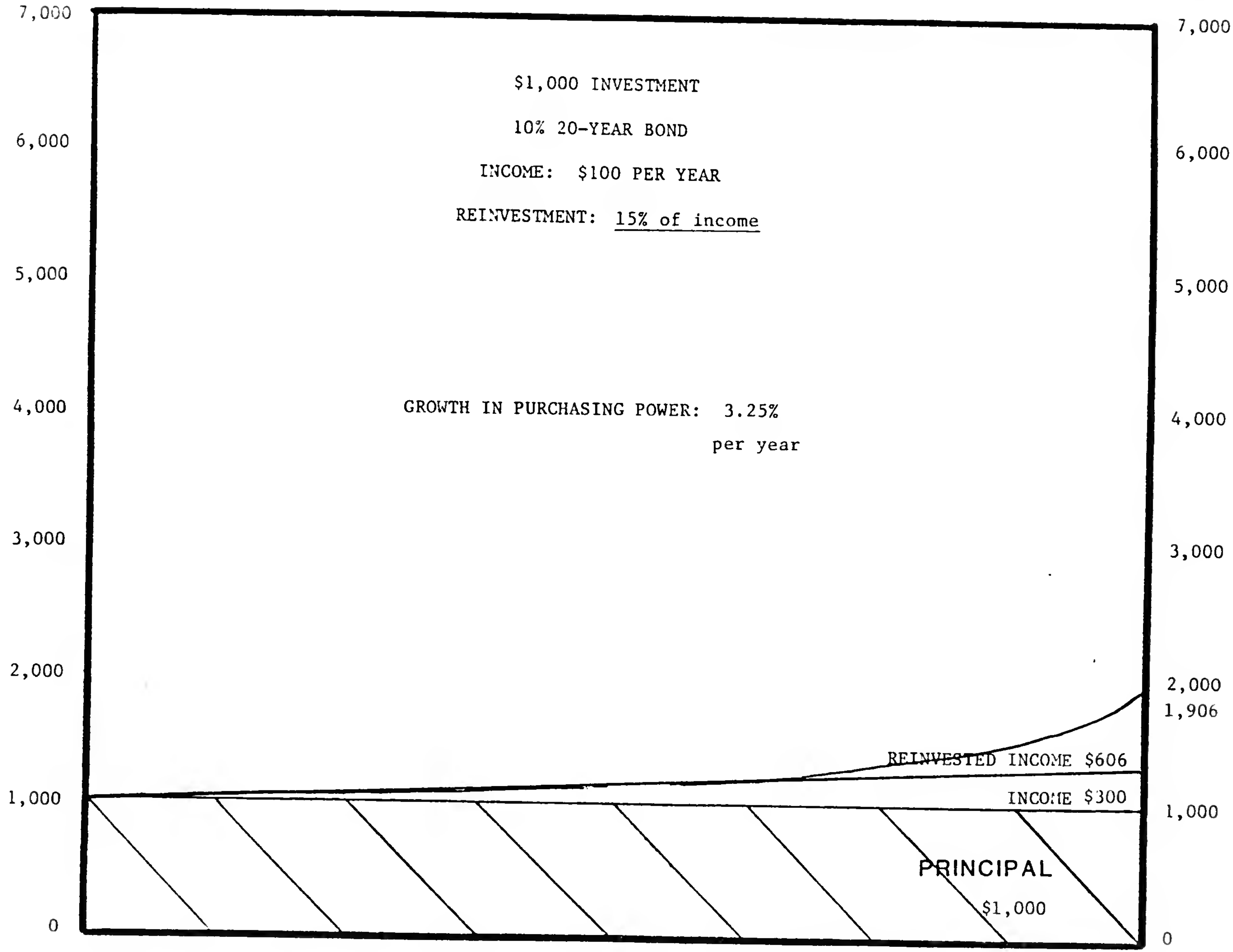
--- THE RETIREMENT FUNDS FROM AN INVESTMENT POINT OF VIEW ARE MEETING INVESTMENT OBJECTIVES

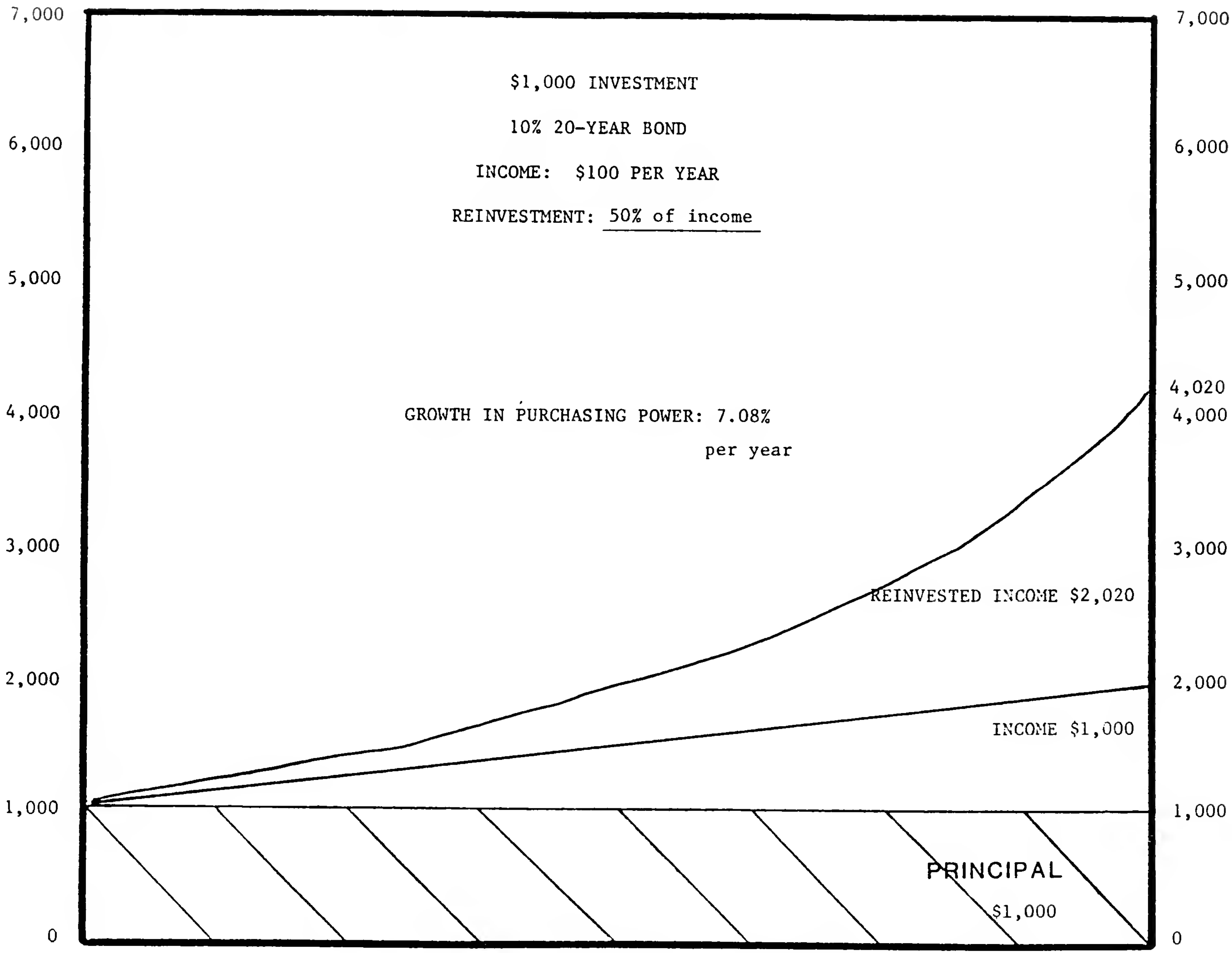
--- THE WORKMAN'S COMP. FUND SHOULD BE ALLOWED A MINORITY EQUITY POSITION IN ORDER TO ACCOMPLISH THE GOAL OF EARNING A REAL RETURN

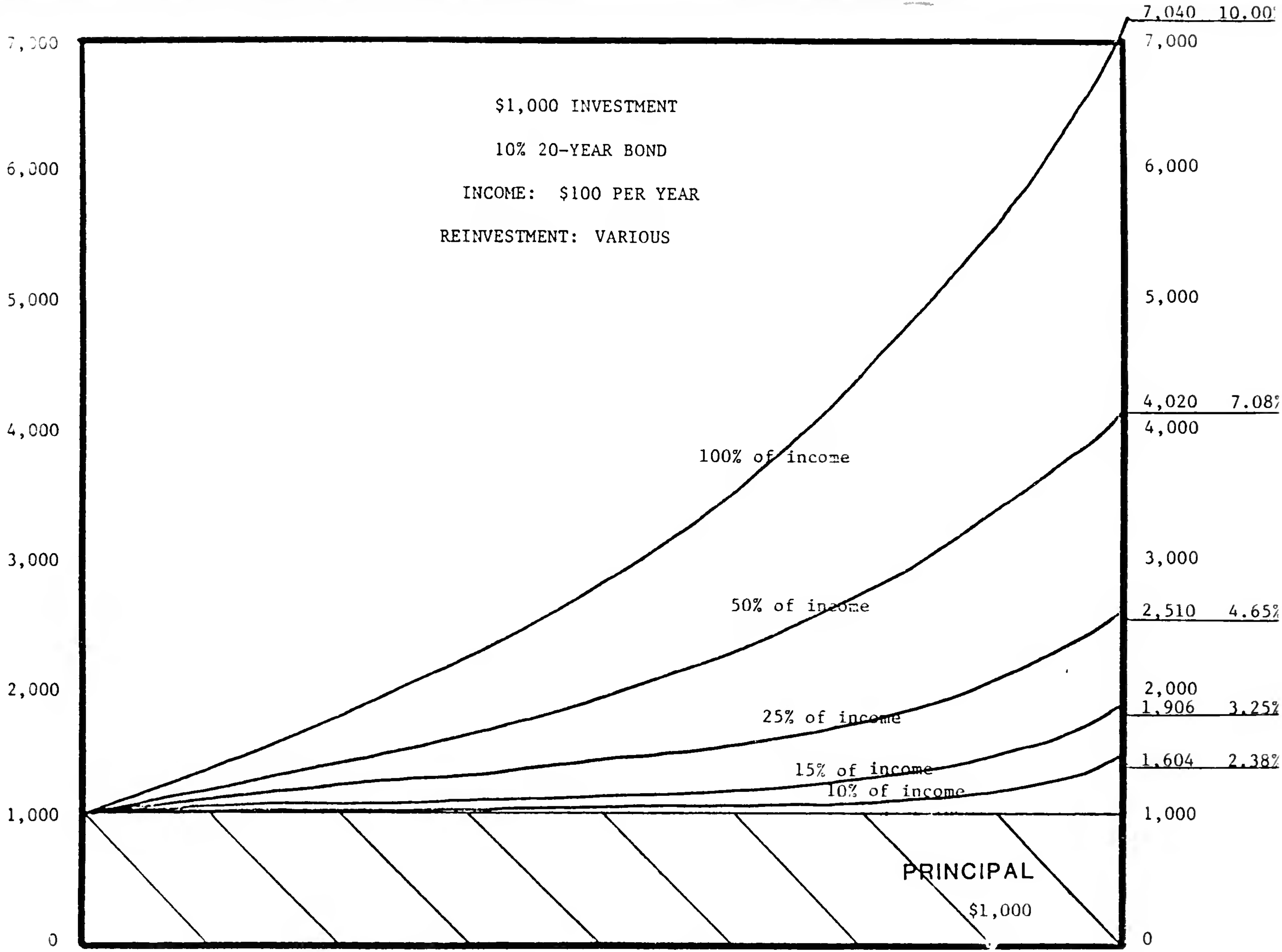


$1,000 INVESTMENT
10% 20-YEAR BOND
INCOME: $100 PER YEAR
REINVESTMENT: ALL INCOME
REINVESTED INCOME
$4,040 = 58%
INCOME
$2,000 = 28%
PRINCIPAL
$1,000 = 14%
7,040
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0


$1,000 INVESTMENT
10% 20-YEAR BOND
INCOME: $100 PER YEAR
REINVESTMENT: 10% of income
GROWTH IN PURCHASING POWER: 2.38% per year
7,000
6,000
5,000
4,000
3,000
2,000
1,604
1,000
0
REINVESTED INCOME
INCOME
PRINCIPAL
$1,000


$1,000 INVESTMENT
10% 20-YEAR BOND
INCOME: $100 PER YEAR
REINVESTMENT: 15% of income
GROWTH IN PURCHASING POWER: 3.25%
per year
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
7,000
6,000
5,000
4,000
3,000
2,000
1,906
1,000
0
REINVESTED INCOME $606
INCOME $300
PRINCIPAL
$1,000


7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
$1,000 INVESTMENT
10% 20-YEAR BOND
INCOME: $100 PER YEAR
REINVESTMENT: 50% of income
GROWTH IN PURCHASING POWER: 7.08% per year
REINVESTED INCOME $2,020
INCOME $1,000
PRINCIPAL
$1,000
7,000
6,000
5,000
4,020
4,000
3,000
2,000
1,000
0



$1,000 INVESTMENT
10% 20-YEAR BOND
INCOME: $100 PER YEAR
REINVESTMENT: VARIOUS
100% of income
50% of income
25% of income
15% of income
10% of income
PRINCIPAL
$1,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
7,040 10.00%
4,020 7.08%
2,510 4.65%
1,906 3.25%
1,604 2.38%

CONCLUSIONS

--- THE TOOLS TO EARN REAL RATES OF RETURN ARE NOT ALLOWED UNDER PRESENT STATUTES

-- Equity investments are not allowed

-- Complete reinvestment of interest and realized gains is not allowed

--- THERE ARE OTHER VALID OBJECTIVES THAT ARE BEING SATISFIED UNDER CURRENT POLICIES AND PROCEDURES

--- THE LEGISLATURE MUST CLARIFY THE TRADE-OFFS IN OBJECTIVES AND PROVIDE THE BOARD OF INVESTMENTS WITH THE TOOLS NEEDED TO MEET THE OBJECTIVES

APPENDIX F

__________ BILL NO. ______

INTRODUCED BY ________________________________

BY REQUEST OF INTERIM JOINT SUBCOMMITTEE NO. 3

A BILL FOR AN ACT ENTITLED: "AN ACT PROVIDING REPRESENTATION FROM THE RETIREMENT SYSTEMS ON THE BOARD OF INVESTMENTS; AMENDING SECTION 2-15-1005, MCA; AND PROVIDING AN IMMEDIATE EFFECTIVE DATE."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MONTANA:

Section 1. Section 2-15-1005, MCA, is amended to read:

"2-15-1005. Board of investments -- allocation -- composition -- quasi-judicial. (1) There is a board of investments.

(2) Except as otherwise provided in this subsection, the board is allocated to the department for administrative purposes only as prescribed in 2-15-121. Personnel for the board shall be appointed by the department subject to the approval of the board, except that the board may employ an investment officer and assistant investment officer who will have general responsibility for management of the board's staff and directing investment activity. The investment officer and assistant investment officer serve at the pleasure of the board, and the board may prescribe the duties and annual salary of both.

(3) The board is composed of ~~five~~ seven members~~,~~. ~~appointed-by-the-governor-as-prescribed-in-2-15-124,~~

(a) The governor shall, in accordance with 2-15-124, appoint five members who are informed and experienced in the subject of investments.

(b) The governor shall appoint one member from the public employees' retirement board provided for in 2-15-1009 and one member from the teachers' retirement board provided for in 2-15-1010, and these appointments are not subject to confirmation by the senate.

(c) If a member appointed to the board of investments under subsection (2)(b) ceases to be a member of the retirement board, a vacancy is created on the board of investments, which the governor shall fill, in accordance with 2-15-124, from the members of the retirement board concerned.

(4) The board is designated as a quasi-judicial board for the purposes of 2-15-124."

NEW SECTION. Section 2. Terms of initial appointees -- successors. (1) The provisions of 2-15-124 notwithstanding:

(a) the member of the public employees' retirement board initially appointed by the governor on or after [the effective date of this act] shall serve on the board of investments until January 1, 1989, and until a successor is

appointed; and

(b) the member of the teachers' retirement board initially appointed by the governor on or after [the effective date of this act] shall serve on the board of investments until January 1, 1987, and until a successor is appointed.

(2) At the completion of each of the initial terms provided for in subsection (1), the governor shall appoint a successor from the concerned retirement board for a term in accordance with 2-15-124.

NEW SECTION. Section 3. Effective date. This act is effective on passage and approval.

-End-

BILL NO. ______

INTRODUCED BY ______________________________

BY REQUEST OF THE

INTERIM JOINT SUBCOMMITTEE NO. 3

A BILL FOR AN ACT ENTITLED: "AN ACT TO AUTHORIZE SECURITIES OF THE FEDERAL HOME LOAN MORTGAGE CORPORATION TO BE PLEDGED TO SECURE DEPOSITS OF PUBLIC FUNDS; AMENDING SECTION 17-6-103, MCA; AND PROVIDING AN EFFECTIVE DATE."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MONTANA:

Section 1. Section 17-6-103, MCA, is amended to read:

"17-6-103. Security for deposits of public funds. The following kinds of securities may be pledged or guarantees may be issued to secure deposits of public funds:

(1) direct obligations of the United States;

(2) securities as to which the payment of principal and interest is guaranteed by the United States;

(3) securities issued or fully guaranteed by the following agencies of the United States or their successors, whether or not guaranteed by the United States:

(a) commodity credit corporation;

(b) federal intermediate credit banks;

(c) federal land bank;

(d) bank for cooperatives;

(e) federal home loan banks;

(f) federal national mortgage association;

(g) government national mortgage association;

(h) small business administration; ~~and~~

(i) federal housing administration; <u>and</u>

<u>(j) federal home loan mortgage corporation;</u>

(4) general obligation bonds of the state or of any county, city, school district, or other political subdivision of the state;

(5) revenue bonds of any county, city, or other political subdivision of the state, when backed by the full faith and credit of such subdivision or when the revenues pledged to the payment of the bonds are derived from a water or sewer system and the issuer has covenanted to establish and maintain rates and charges for the system in an amount sufficient to produce revenues equal to at least 125% of the average annual principal and interest due on all bonds payable for such revenues during the outstanding term of such bonds;

(6) interest-bearing warrants of the state or of any county, city, school district, or other political subdivision of the state issued in evidence of claims in an amount which, with all other claims on the same fund, do not exceed the amount validly appropriated in the current budget for expenditure from the fund in the year in which they are

issued;

(7) obligations of housing authorities of the state secured by a pledge of annual contributions or by a loan agreement made by the United States or any agency thereof providing for contributions or a loan sufficient with other funds pledged to pay the principal of and interest on the obligations when due. Subject to rules prescribed by the department of commerce, the bonds and other obligations made eligible for investment in 32-1-424(3) and 7-15-4505 may be used as security for all deposits of public funds or obligations for which depository bonds or any kind of bonds or other securities are required or may by law be deposited as security.

(8) general obligation bonds of other states and of municipalities, counties, and school districts of other states;

(9) undertaking or guarantees issued by a surety company authorized to do business in the state;

(10) first mortgages and trust indentures on real property. The depository shall, on a quarterly basis, certify to the state treasurer that sufficient first mortgages and trust indentures on real property are available and segregated to secure deposits of public funds. The board of investments shall determine the amount of security required.

(11) bonds issued pursuant to Title 7, chapter 12, parts 21 and 41;

(12) bonds issued pursuant to Title 90, chapter 6, part 1;

(13) revenue bonds issued by any unit of the university system of the state of Montana; and

(14) advance refunded bonds secured by direct obligations of the United States treasury held in irrevocable escrow."

NEW SECTION. Section 2. Effective date. This act is effective July 1, 1985.

-End-

BILL NO. ______

INTRODUCED BY ________________________________

BY REQUEST OF THE

INTERIM JOINT SUBCOMMITTEE NO. 3

A BILL FOR AN ACT ENTITLED: "AN ACT TO ALLOW FOUR ADDITIONAL EXEMPT POSITIONS ON THE STAFF OF THE BOARD OF INVESTMENTS; AMENDING SECTIONS 2-15-1005 AND 2-18-103, MCA; AND PROVIDING AN EFFECTIVE DATE."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MONTANA:

Section 1. Section 2-18-103, MCA, is amended to read:

"2-18-103. Officers and employees excepted. Parts 1 and 2 do not apply to the following positions in state government:

(1) elected officials;

(2) county assessors and their chief deputy;

(3) officers and employees of the legislative branch;

(4) judges and employees of the judicial branch;

(5) members of boards and commissions appointed by the governor, appointed by the legislature, or appointed by other elected state officials;

(6) officers or members of the militia;

(7) agency heads appointed by the governor;

(8) academic and professional administrative personnel

with individual contracts under the authority of the board of regents of higher education;

(9) academic and professional administrative personnel and live-in houseparents who have entered into individual contracts with the state school for the deaf and blind under the authority of the state board of public education;

(10) teachers under the authority of the department of institutions;

(11) investment officer<u>,</u> and assistant investment officer<u>, and four professional investment staff positions</u> of the board of investments; and

(12) four professional staff positions under the board of oil and gas conservation."

Section 2. Section 2-15-1005, MCA, is amended to read:

"2-15-1005. Board of investments -- allocation -- composition -- quasi-judicial. (1) There is a board of investments.

(2) Except as otherwise provided in this subsection, the board is allocated to the department for administrative purposes only as prescribed in 2-15-121. Personnel for the board shall be appointed by the department subject to the approval of the board, except that the board may employ an investment officer and assistant investment officer<u>,</u> who will have general responsibility for management of the board's staff and directing investment activity<u>, and four</u>

professional investment staff members. The investment officer, ~~and~~ assistant investment officer, and four professional investment staff members serve at the pleasure of the board, and the board may prescribe the duties and annual salary of ~~both~~ each.

(3) The board is composed of five members, appointed by the governor as prescribed in 2-15-124, informed and experienced in the subject of investments.

(4) The board is designated as a quasi-judicial board for the purposes of 2-15-124."

NEW SECTION. Section 3. Effective date. This act is effective July 1, 1985.

-End-

BILL NO. ______

INTRODUCED BY ______________________________

BY REQUEST OF JOINT INTERIM SUBCOMMITTEE NO. 3

A BILL FOR AN ACT ENTITLED: "AN ACT TO SUBMIT TO THE QUALIFIED ELECTORS OF MONTANA AN AMENDMENT TO ARTICLE VIII, SECTION 13, OF THE MONTANA CONSTITUTION REMOVING THE RESTRICTIONS ON INVESTMENT OF PUBLIC FUNDS AND PROVIDING THAT THE "PRUDENT EXPERT" PRINCIPLE GOVERN THE INVESTMENT OF PUBLIC FUNDS."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MONTANA:

Section 1. Article VIII, section 13, of the Constitution of the State of Montana is amended to read:

"Section 13. Investment of public funds. (1) The legislature shall provide for a unified investment program for public funds and provide rules therefor, including supervision of investment of surplus funds of all counties, cities, towns, and other local governmental entities. Each fund forming a part of the unified investment program shall be separately identified. ~~Except for monies contributed to retirement funds, no public funds shall be invested in private corporate capital stock.~~ The investment program shall be audited at least annually and a report thereof submitted to the governor and legislature.

(2) ~~The public school fund and the permanent funds of the Montana university system and all other state institutions of learning shall be safely and conservatively invested in:~~

~~(a) Public securities of the state, its subdivisions, local government units, and districts within the state, or~~

~~(b) Bonds of the United States or other securities fully guaranteed as to principal and interest by the United States, or~~

~~(c) Such other safe investments bearing a fixed rate of interest as may be provided by law.~~ The unified investment program shall be administered as provided by law, and any investment manager shall discharge his duties with the care, skill, prudence, and diligence expected of a prudent expert."

NEW SECTION. Section 2. Effective date. If approved by the electorate, this amendment is effective January 1, 1987.

NEW SECTION. Section 3. Submission to electorate. This amendment shall be submitted to the electors of the state of Montana at the general election to be held November 4, 1986, by printing on the ballot the full title of this act and the following:

FOR removing the restrictions on investment of public funds and providing that the "prudent expert"

principle govern the investment of public funds.

AGAINST removing the restrictions on investment of public funds and providing that the "prudent expert" principle govern the investment of public funds.

-End-

BILL NO. ______

INTRODUCED BY ______________________________

BY REQUEST OF JOINT INTERIM SUBCOMMITTEE NO. 3

A BILL FOR AN ACT ENTITLED: "AN ACT CONFORMING THE UNIFIED INVESTMENT PROGRAM WITH CONSTITUTIONAL AMENDMENTS IN ____ BILL ___ [LC 15], WHICH AMENDMENTS REMOVE RESTRICTIONS ON INVESTMENT OF PUBLIC FUNDS AND PROVIDE A "PRUDENT EXPERT" STANDARD FOR INVESTMENT OF PUBLIC FUNDS; AMENDING SECTIONS 17-6-201, 17-6-211, AND 17-6-324, MCA; AND PROVIDING A DELAYED EFFECTIVE DATE."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MONTANA:

Section 1. Section 17-6-201, MCA, is amended to read:

"17-6-201. Unified investment program -- general provisions. (1) The ~~uniform~~ unified investment program directed by Article VIII, section 13, of the 1972 Montana constitution to be provided for public funds shall be administered by the board of investments and the Montana economic development board in accordance with the ~~rules provided in this chapter and with that degree of judgment and care, under circumstances from time to time prevailing, which people of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation but for investment, considering the probable safety of their capital as well as the probable income to be derived, and preservation of purchasing power of capital during periods of sustained high monetary inflation. Investments by the Montana economic development board are limited to those made from the Montana in-state investment fund and for the purposes set forth in part 3.~~

~~(2) All state funds shall be invested and reinvested in securities enumerated in 17-6-211 to the maximum extent consistent with this policy and with the need and timing of cash expenditures for particular purposes~~ prudent expert principle which requires any investment manager to:

(a) discharge his duties with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of a like character with like aims;

(b) diversify the holdings of each fund within the unified investment program to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so; and

(c) discharge his duties solely in the interest of and for the benefit of the funds forming the unified investment program.

~~(3)~~(2) The board of investments has the sole authority

to invest state funds other than the Montana in-state investment fund. No other agency may invest such state funds. The board shall direct the investment of state funds in accordance with the laws and constitution of this state. The board has the power to veto any investments made under its general supervision.

~~(4)~~(3) The board of investments shall:

(a) assist agencies with public money to determine if, when, and how much surplus cash is available for investment;

(b) determine the amount of surplus treasury cash to be invested;

(c) determine the type of investment to be made; and

(d) prepare the claim to pay for the investment.

~~(5)~~(4) The board of investments may:

(a) execute deeds of conveyance transferring all real property obtained through foreclosure of any investments purchased under the provisions of 17-6-211 when full payment has been received therefor;

(b) direct the withdrawal of any funds deposited by or for the state treasurer pursuant to 17-6-101 and 17-6-105;

(c) direct the sale of any securities in the program at their full and true value when found necessary to raise money for payments due from the treasury funds for which the securities have been purchased.

~~(6)~~(5) The state treasurer shall keep an account of

the total of each investment fund and of all the investments belonging to such fund and of the participation of each treasury fund account therein and shall make from time to time such reports with reference thereto as may be directed by the board of investments.

~~(7)~~(6) The cost of administering and accounting for each investment fund shall be deducted from the income therefrom, except that such costs of the nonexpendable trust funds shall be paid from income otherwise receivable from the pooled investment fund, and the amounts required for this purpose shall be appropriated by the legislature from the respective investment funds."

Section 2. Section 17-6-211, MCA, is amended to read:

"17-6-211. ~~Permissible---investments~~ Preference to in-state investment firms -- commitment agreement with board of housing. ~~(1)-The--following--securities--are--permissible investments---for---all--investment--funds--referred--to--in 17-6-203,-except-as-indicated:~~

~~(a)--any-securities-authorized-to-be-pledged-to--secure deposits-of-public-funds-under-17-6-103;~~

~~(b)--bonds,--notes,--debentures,-equipment-obligations, or-any-other-kind-of-absolute-obligation-of-any--corporation organized-and-operating-in-any-state-of-the-United-States-or in--Canada,--if--the--obligations--purchased--are-payable-in United-States-dollars,-or-of-any-corporation--in--which--the~~

~~United States government is a voting shareholder by act of congress, provided that all investments under this subsection (1)(b) must be rated by one nationally recognized rating agency among the top third of their quality categories, not applicable to defaulted bonds;~~

~~(c) commercial paper of highest quality, as defined by one nationally recognized rating agency, issued by any corporation organized and operating in any state of the United States, provided that:~~

~~(i) such securities mature in 270 days or less;~~

~~(ii) the issuing corporation or the parent company of a finance subsidiary issuing commercial paper, at the time of the last financial reporting period, had received net income averaging $1 million or more annually for the preceding 5 years; and~~

~~(iii) no investment may be made at any time under this subsection (1)(c) which would cause the book value of such investments in any investment fund to exceed 10% of the book value of such fund or would cause the commercial paper of any one corporation to exceed 2% of the book value of such fund;~~

~~(d) bankers' acceptances guaranteed by any bank having its principal office in any state of the United States and having deposits in excess of $500 million;~~

~~(e) interest bearing deposits in banks, building and~~

~~loan associations, savings and loan associations, and credit unions located in Montana, provided, however, that the board of investments shall require pledged securities as specified in 17-6-102 (interest on said deposits shall not be less than the prevailing rate of interest being paid on deposits of private funds);~~

~~(f) unencumbered real property, first mortgages, and participations in first mortgages on unencumbered real property as provided in this subsection (1)(f) and subsection (5), provided that:~~

~~(i) no such mortgage or mortgage participation may be purchased unless:~~

~~(A) the principal amount of the loan secured by the mortgage or mortgage participation is 80% or less of the appraised value of the property;~~

~~(B) the principal amount of the loan secured by the mortgage or mortgage participation exceeds 80% of the appraised value of the property but the amount of the loan in excess of 80%, determined at the time the loan was made, is guaranteed or insured by a mortgage insurance company which the board of investments has determined to be a qualified private insurer;~~

~~(C) 25% or more of the loan or participation therein secured is guaranteed or insured in the event of default by the United States of America or an agency thereof; or~~

~~(D)--the-mortgagor-has-leased-the-mortgaged-property-to a-person,-firm,-or-corporation-whose-rental--payments--under the--lease--are--guaranteed-for-the-full-term-of-the-loan-or participation-therein-by-an-agency-of-the-United-States;-and~~

~~(ii)-no-investment-shall-be--made--at--any--time--under subsection--(1)(f)--which-would-cause-the-book-value-of-such investments-in-any-investment-fund-to-exceed-50%-of-the-book value-of-such-fund;-and~~

~~(g)--any-other-investment-in-any-business--activity--in the--state,-including-activities-that-continue-existing-jobs or-create-new-jobs-in--Montana,--provided--that--investments which--do--not--meet--the-requirements-of-subsections-(1)(a) through-(1)(f)-may-not,-in-the-aggregate,-exceed-10%-of--the fund-from-which-each-such-investment-is-made.~~

~~(2)--Investments--from-the-pooled-investment-fund-shall be--restricted--to--fixed--income--securities--described--in subsections-(1)(a)-to-(1)(e)-above.~~

~~(3)--Retirement--funds--and--the--fund--provided-for-in 17-6-203,-subsection-(4)-may-be-invested--in--preferred--and common--stocks-of-any-corporation-organized-and-operating-in any-state-of-the-United-States,-provided-that:~~

~~(a)--the-corporation-has-assets-of--a--value--not--less than-$10-million;~~

~~(b)--if---the---investment---is--preferred--stock,--the corporation's-aggregate-earnings-available--for--payment--of~~

~~interest---and--preferred--dividends,--for--a--period--of--5 consecutive-years-immediately-before-the-date-of-investment, have-been-at-least-1-1/2-times-the-aggregate-of-interest-and preferred-dividends-required-to-be-paid-during-this--period;~~

~~(c)--no--investment--may--be--made--at--any--time-under subsection-(3)-which-would-cause--the--book--value--of--such investments-in-any-retirement-fund-to-exceed-50%-of-the-book value--of--such--fund--or--would--cause--the--stock--of--one corporation--to--exceed--2%--of--the--book--value--of---such retirement-fund;~~

~~(d)--subsection-(3)(c)-does-not-apply-to-funds-provided for-in-17-6-203(4).~~

~~(4)~~(1) The board of investments shall endeavor to direct its portion of the state's investment business to those investment firms and/or banks which maintain offices in the state and thereby make contributions to the state economy. Further, due consideration shall be given to investments which will benefit the smaller communities in the state. The state's investment business will be directed to out-of-state firms only when there is a distinct economic advantage to the state of Montana.

~~(5)~~(2) ~~The-board-may-invest-in-mortgage-loans-financed by-the-board-of-housing-if-the-mortgages-are-not-in--default and--meet--the--requirements-of-subsection-(1)(f).~~ The board may enter into a commitment agreement with the board of

housing at the time of an issue of bonds or notes by the board of housing providing for the purchase at a specified future date, not to exceed 15 years from the date of the issue, of all or any portion of the amount of mortgage loans purchased with the proceeds of the issue. The board of investments may charge reasonable fees for any commitment and may agree to purchase the mortgage loans on terms that in the judgment of the board of investments provide a fair market rate of return to the purchasers.

~~(6) The Montana economic development board created in 2-15-1805 may invest the Montana in-state investment fund in any in-state investment authorized by its rules in addition to those investments authorized by this section.~~"

Section 3. Section 17-6-324, MCA, is amended to read:

"17-6-324. Rulemaking authority. The board may adopt rules to implement the provisions of this part and 17-6-211~~(5)~~(2). Rules adopted by the board may include definitions of small- and medium-sized businesses, a method of committing funds to financial institutions, types of service fees, and types of investments to be made. The board may also adopt procedural rules to govern its proceedings."

NEW SECTION. Section 4. Effective date. This act is effective January 1, 1987.

NEW SECTION. Section 5. Coordination instruction. If ____ Bill No. __ [LC 15], including the section of that bill

amending Article VIII, section 13, of the Constitution of the State of Montana, fails upon submission to the electorate on November 4, 1986, this act is void in its entirety.

-End-

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